Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1977

No. 77-1049

ST. LOUIS UNION TRUST COMPANY, a Corporation, KENNETH H. BITTING, JR., WILLIAM C. BITTING and GEORGE C. BITTING, as Executors of the Last Will of Kenneth H. Bitting, Deceased,
Petitioners,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Corporation, DONALD T. REGAN, NED B. BALL and GEORGE L. SHINN,
Respondents.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit

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To the United States Court of Appeals for the Eighth Circuit

Petitioners St. Louis Union Trust Company, Kenneth H. Bitting, Jr., William C. Bitting and George C. Bitting pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit in this action which (a) reversed the district court's judgment awarding petitioners almost $4,000,000 in damages and (b) ordered dismissal of the Complaint.

OPINIONS BELOW

The Opinion of the United States District Court for the Eastern District of Missouri is reported at 412 F.Supp. 45 and reproduced in Appendix A hereto. The district court's judgment appears in Appendix B.

The majority and dissenting opinions of the United States Court of Appeals for the Eighth Circuit are reported at 562 F.2d 1040 and reprinted in Appendix C. The Court of Appeals' judgment appears in Appendix D, and the Order dated October 27, 1977 denying rehearing and rehearing *en banc* is set forth in Appendix E.

JURISDICTION

The judgment of the Court of Appeals was entered on August 26, 1977. Petitioners' timely petition for rehearing was denied on October 27, 1977. This petition is being filed within 90 days of October 27, 1977.

The jurisdiction of this Court is founded on 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Does § 10(b) of the Securities Exchange Act of 1934 permit a corporate insider to enhance his position and the value of his own shares by manipulating corporate machinery to cause the purchase of the corporation's shares from minority shareholders at a predetermined price without disclosing important facts indicating that the stock is worth substantially more than that price?

2. Did the Court of Appeals correctly determine that respondents' actions and nondisclosures were immaterial as a matter of law and that petitioners had failed to prove causation?

3. May a federal court refuse to apply clearly controlling and well-settled principles of state law in a diversity case?

4. Does a corporate officer or director violate his fiduciary duty by using corporate machinery to effectuate a transaction which produces a substantial benefit to him and is unfair to the minority shareholders?

STATUTE AND RULE INVOLVED

This case involves § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, both of which are set forth in Appendix F hereto.

STATEMENT OF THE CASE

In March 1976, the United States District Court for the Eastern District of Missouri (Honorable James H. Meredith, Chief Judge) entered a judgment in favor of petitioners and against Merrill Lynch, Pierce, Fenner & Smith, Inc., and three of its top officers and directors in the amount of almost $4,000,000, including prejudgment interest and punitive damages. The court, after a lengthy non-jury trial, filed a 33-page Memorandum containing 57 detailed findings of fact and a number of conclusions of law. In summary, the trial judge found that the defendants, respondents here, had made a secret decision in mid-1970 that Merrill Lynch would "go public" in early 1971 and that while they were diligently and covertly pursuing that goal, they caused certain restrictions on Merrill Lynch stock contained in the Company's Articles of Incorporation to be used to call

the stock of deceased and retiring shareholders, including petitioners' decedent, at a fraction of its true value. The court concluded that respondents' conduct had produced ill-gotten gains of some $38,000,000 and that respondents were guilty of common law fraud, a violation of the federal securities laws and a breach of their fiduciary duties under the law of Delaware.[1]

On August 26, 1977, a three-judge panel of the Eighth Circuit reversed the district court's judgment in a two-to-one decision and ordered a dismissal of the Complaint. The majority opinion, written by Judge Ross and joined in by Judge Stephenson, held that the decision to go public, no matter how definite, refined or imminent, was "immaterial" as a matter of law because respondents had the absolute right under the charter to force petitioners to sell their stock at "book value," regardless of respondents' motivations or knowledge of corporate plans, and irrespective of the fairness of the transaction. Judge Heaney dissented, arguing that the clearly proven facts established respondents' liability for actual damages.

In view of the Court of Appeals' acceptance of the district court's well-documented findings concerning the timing of the decision to go public and the personal gain to respondents, this case presents clear-cut and significant questions of corporate and securities law which are of general importance throughout the country and should be resolved by this Court. The standard of conduct sanctioned by the Court of Appeals represents a dramatic departure from the high level of integrity and fair dealing heretofore demanded of fiduciaries.

The following fact findings of the district court (which are set forth in Appendix A, *post*, pp. A-1 to A-31) were not disturbed by the Court of Appeals and are accurately recited in Judge Heaney's dissent:

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[1] The jurisdiction of the district court was predicated on diversity of citizenship as well as the federal securities laws. The case was not prosecuted as a class action.

On July 14, 1970, a tightly-knit top-management clique headed by respondents Regan and Shinn made a decision that Merrill Lynch, the world's largest brokerage house, would cease to be closely held and would offer its shares to the public, with a proposed target date of Spring 1971. This decision was initially kept strictly confidential and, prior to April 1971, was revealed only to a few selected individuals. In particular, the plans for going public were concealed from James Thomson, Merrill Lynch's Chairman who was being "eased out," and from Board Member Darwin Fenner, the largest single stockholder, who was contemplating voluntary retirement.[2]

In the wake of the July 1970 decision, the "Going Public Task Force," headed by Shinn, made extensive and elaborate preparations for a public offering, including the retention of counsel to draft a prospectus and the engagement of Haskins and Sells to perform a ten-year audit and prepare financial statements for inclusion in the Registration Statement. On October 7, 1970, the Task Force submitted its "mid-point" report to Shinn containing a timetable calling for the filing of a Registration Statement with the S.E.C. on March 1, 1971.

On October 8, 1970, Kenneth H. Bitting died. Pursuant to a "call option" contained in Article VI of its Certificate of Incorporation, Merrill Lynch, on November 18, 1970, sent a letter to petitioners (the executors of Bitting's estate) stating that it intended to use that charter restriction to purchase the 40,000 shares of Merrill Lynch stock owned by Bitting at the time of his death.[3] On the very same day, the Task Force was meeting

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[2] Much later, in the summer of 1971, defendants twice publicly acknowledged in the Merrill Lynch house organ "We The People" that the decision to go public had indeed been made on July 14, 1970.

[3] The district court found that the purpose of the Article VI restriction was to comply with a regulation of the New York Stock Exchange which prohibited public ownership of the stock of member firms. 412 F.Supp. at 48-49. That regulation, however, had been repealed by the Exchange on March 26, 1970. *Id.* at 50.

with the S.E.C. to discuss the Merrill Lynch prospectus, which they were "in the process of preparing."

On December 18, the Task Force prepared its recommendations for Regan, the President of Merrill Lynch, about the size, composition and other details of the public offering. On December 30, Regan finalized the decision as to the number of shares to be offered, the three-for-one stock split and the necessary charter amendments to be submitted to the directors. Also on that date, Merrill Lynch consummated its purchase of petitioners' stock by mailing them a check for the purchase price.[4]

On December 31—the very next day—Thomson, Fenner and seven other key officers holding a total of 2,302,200 post-split shares of Merrill Lynch stock voluntarily took early retirement. These retirees were completely unaware of the going-public plans, and the charter restriction was used to purchase 60% of their shares.[5]

As late as March 9, 1971, Regan falsely told the Board of Directors that no decision had been made concerning public ownership. Finally, on April 17, he informed the Board for the first time that the Company was going public and was ready to file its Registration Statement. At that time the Board voted to suspend the exercise of stock restrictions contained in the charter. On April 23, the Registration Statement was filed, and it became effective on June 23.

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[4] As a result of some negotiations, Bitting's widow was permitted to repurchase 10,000 of these shares at the same price.

[5] Fenner testified that he had said to Regan in late 1970: ". . . [I]f you have any idea of going public, for God's sake tell me. I just won't retire." Regan replied that he had no such idea. Thomson testified that he was "shocked" when Merrill Lynch announced its public offering just three months after his retirement. The Court of Appeals was advised at oral argument, in response to an inquiry from the bench, that both Fenner and Thomson, among others, have asserted claims against Merrill Lynch but have agreed to defer further proceedings until final disposition of this case.

During 1970, the number of outstanding Merrill Lynch shares had been reduced from 11,033,612 to 9,728,056. According to respondents' own calculations, this reduction had the effect of creating a "windfall" to respondents and other remaining shareholders of almost 12% over and above the three-fold increase in the stock's value attributable to the public offering itself. In addition, this purposeful contraction of outstanding shares eliminated a number of large blocs of stock (such as Fenner's) which could have jeopardized respondents' control after the public offering.

As a result of the "windfall" caused by the reduction in shares, Regan's stock increased in value by an aggregate amount of $964,000, Shinn's by $211,000 and Ball's by $501,000. Additionally, because of the concealment of the plans for public ownership, Thomson was induced to retire at the end of 1970, thus permitting Regan to move into the Chairman's office and Ball to assume the presidency of Merrill Lynch. The district judge found that the veil of secrecy surrounding the going-public scheme was utilized for the purpose of maintaining management control and increasing the offering price of the stock at the public offering. Despite an intensive assault on these findings by Merrill Lynch, the Eighth Circuit did not set any of them aside, for indeed they are abundantly supported by the record.[6]

Petitioners' shares were called at a price of approximately $26.50 per share. They were then split three-for-one and sold

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[6] The panel majority did question whether the individual respondents personally played a causal role in the calling of petitioners' stock (562 F.2d at 1044, n. 4). The record is clear, however, that the tight web of secrecy woven by respondents prevented the Board from suspending the exercise of the restrictions, which it immediately did in April 1971 when first advised of the plans for going public. Petitioners' loss was not caused by Mr. Bitting's death, as suggested by the majority, but by the conscious and secretive actions of respondents which caused the Corporation to continue exercising a charter restriction which no longer served its stated purpose of complying with since-repealed regulations of the New York Stock Exchange

to the public for $28.00 per share. Hence if petitioners had still owned their stock, it would have been worth $84.00 per share. The trial court found that, overall, the use of charter restrictions during the relevant period resulted in a net gain to the Corporation of $38,000,000.

The record here unmistakably shows that respondents' behavior was not accidental but carefully calculated. Among other things, respondents consciously ignored the concerns voiced by two corporate officers about "the possible moral and legal responsibility to stockholders who retire during the period after the decision is reached to go public but before an actual offering is made." Yet, in the face of this clearly proven scheme of deception, nondisclosure, self-aggrandizement and unfairness, the Eighth Circuit panel majority held that respondents had the absolute contractual right to enforce the charter restriction—irrespective of purpose or surrounding circumstances—and had no federal, state or common-law duty to deal fairly with petitioners.

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requiring member firms to be closely held. See Judge Heaney's dissent, 562 F.2d at 1055, n. 1.

The only other quarrel by the appellate court with the pertinent facts appears in footnote 7 (562 F.2d at 1044-45) where the majority said:

> ". . . There was no fraud on the part of the defendants *prior to* November 18, 1970, at least as such alleged fraud may have applied to *Bitting*. To the extent that the district court held to the contrary, we consider his factual findings to be clearly erroneous." (Emphasis added.)

The import of this unexplicated holding is elusive because petitioners never contended that Kenneth Bitting himself had been defrauded. Moreover, the exercise of the option did not begin until November 18 and was not completed until after December 30, so that even if the court's statement was meant to refer to petitioners rather than to their decedent, it is irrelevant to the issues presented by this petition.

REASONS WHY THE WRIT SHOULD BE GRANTED

I. The Court of Appeals Has Misapplied the Decisions of This Court So as to Exempt From Coverage Under Section 10(b) Deceptive Securities Transactions Perpetrated by Corporate Officers and Directors Through Misrepresentation and Nondisclosure and in Breach of Their Fiduciary Duties; the Decision Below Also Creates a Conflict Among the Circuits in the Enforcement of the Federal Securities Laws.

The Eighth Circuit panel majority applied a stilted, highly technical and clearly erroneous reading of Section 10(b) and Rule 10b-5 in this case to exculpate respondents from the consequences of their actions. Besides disregarding the oft-repeated admonition of cases such as *Superintendent of Insurance v. Bankers' Life & Casualty Co.*, 404 U.S. 6, 12 (1971), that "Section 10(b) must be read flexibly, not technically and restrictively," the Court of Appeals has (a) misapplied *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), and *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); (b) flatly disagreed with *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied* 429 U.S. 1010 (1976), and (c) created a conflict with the reasoning of the Second Circuit in *Drachman v. Harvey*, 453 F.2d 722, 736 (2d Cir. *en banc* 1972) and *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. *en banc* 1968); the Fifth Circuit in *Coffee v. Permian Corporation*, 474 F.2d 1040 (5th Cir. 1973), *cert. denied*, 412 U.S. 920 (1973); and the Seventh Circuit in *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976).

The cornerstone of the panel majority's ruling under § 10(b) was that respondents' misrepresentations and nondisclosures were not "material" because petitioners were contractually com-

mitted to sell their stock at respondents' option.[7] The majority blindly followed the questionable rationale of *Ryan v. J. Walter Thompson Co.*, 453 F.2d 444 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972), which was governed by New York law, and in the process oversimplified the issue and misconstrued the controlling legal principles. The panel's conclusion that the misrepresentations and nondisclosures were legally immaterial because petitioners would have had no recourse if they had known the truth (562 F.2d at 1050) is factually and legally incorrect and begs the question. Admittedly, if the Eighth Circuit's ultimate conclusion was correct, then petitioners were at the mercy of respondents, but fundamental concepts of fairness—and the decisions of this Court—dictate that petitioners were entitled (a) to know all the facts and (b) to test respondents' "right" to call their stock at a fraction of its true value. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). Moreover, if the decision to go public had not been cloaked in secrecy, the Merrill Lynch Board unquestionably would have suspended the restriction (as it did when it was ultimately advised of the plan in April), and petitioners' stock never would have been called. Hence, respondents' scheme and nondisclosure proximately caused the call of petitioners' stock and their resultant loss.

The panel majority analyzed the "materiality" issue in the following terms, 562 F.2d at 1049-50:

> "Any information concerning the public offering was not 'material' in the sense that a reasonable or objective

[7] For present purposes only, we are assuming *arguendo* that the charter restriction was still valid after the decision to go public had been made. Although the Court of Appeals majority misconstrued our argument as to the validity of the restriction and erred in holding the restriction to be exercisable after it no longer served any valid corporate purpose, it is not necessary for petitioners to attack the validity of the option *per se* in order to prevail under either § 10(b) or Delaware state law. However, if certiorari is granted, petitioners will contest the Court of Appeals' conclusion that the option was still exercisable after Merrill Lynch had determined to abandon its status as a close corporation.

> investor, in the plaintiff's circumstances would likely have considered it important in making its decision to sell . . . The defendants were thus under no obligation—and had no fiduciary 'duty' under §10(b) and Rule 10b-5—to disclose any information to the plaintiffs concerning the public offering when the stock restriction was enforced."

The Court of Appeals therefore rejected the lower court's finding of materiality and ruled *as a matter of law* that a stockholder would not be interested in knowing that his stock was about to triple in value. We cannot square that holding with the concept of materiality articulated in *TSC Industries, Inc. v. Northway, Inc., supra* at 449, where the Court said that "an omitted fact is material if there is substantial likelihood that a reasonable shareholder would consider it important in deciding" whether to take the action requested.[8]

The Court of Appeals' materiality analysis was as flawed as it was simplistic. As demonstrated below in Point II, respondents' right to call petitioners' stock under Delaware law depended on the fairness of the transaction. Thus, if petitioners had known of the plans for going public, they could have litigated the fairness of the exercise of the option under the prevailing circumstances. In a very similar context, the Seventh Circuit recently highlighted the logical loopholes in the majority opinion below:

> ". . . the minority shareholders would have had the right to bring a derivative action in the state court on

[8] The majority's observation (562 F.2d at 1049, n. 13) that petitioner George Bitting was told that Merrill Lynch might go public "but that the company could call the stock irrespective of any future public offering" is *completely* unsupported by the record. On the contrary, George Bitting, who handled the transaction for the estate, testified that he would have vigorously resisted respondents' efforts to call the stock if he had been accurately apprised of the status of the plans for a public offering.

behalf of the corporation to enjoin any breach of [defendant's] fiduciary duty to deal fairly . . . The minority shareholders are thus afforded the same right they would have had if full disclosure had been made, *i.e.*, the right to obtain a judicial determination of the fairness of a transaction forced upon the corporation by a controlling shareholder with a conflict of interest. *The existence of a causal link between [defendant's] technical violation of Rule 10b-5 and the consummation of the . . . transaction depends, therefore, on the fairness of the transaction." Wright v. Heizer Corporation*, 560 F.2d 236, 250 (7th Cir. 1977), *pet. for cert. filed*, 46 U.S.L.W. 3400 (12/7/77) (No. 77-814).[9]

So too here, since the exercise of the option was a breach of respondents' fiduciary duty and was unfair to the minority shareholders, the conclusion that respondents' nondisclosure was immaterial is completely untenable. Full disclosure would have resulted in petitioners' stock not being called or, at the very least, would have triggered a challenge of respondents' right to call the stock at book value under the existing circumstances. For the reasons stated in Point II, *post*, respondents could not have survived such a challenge, and the majority's contrary conclusion was wrong as a matter of law.

In *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra*, the Third Circuit reached a result flatly contrary to the decision below in a case arising out of the very same Merrill Lynch public offering and involving the call of another ex-employee's stock. The Third Circuit rejected Merrill Lynch's contention that *Ryan v. J. Walter Thompson Co., supra*, was controlling and made nondisclosure irrelevant. Citing the district court's opinion in this case, the Third Circuit held that the plain-

[9] Emphasis ours here and throughout this Petition unless otherwise indicated.

tiff in *Ayres* had stated a viable claim for relief under both federal and state law.[10]

This is not a case of simple internal corporate mismanagement. Nor is this an attempt to federalize the state corporation law. This is, rather, a case in which the top executives of the largest brokerage house in the world have deceived and taken unfair advantage of the widows and children of their own shareholders in transactions involving Merrill Lynch's very own stock. Respondents, more than anyone else, should be expected to adhere to the rules which govern their industry. But here they have been enriched through manipulation, deception and nondisclosure, and their violation of fiduciary duties in connection with their transactions in Merrill Lynch stock clearly creates a §10(b) cause of action under the rationale of numerous cases such as *Drachman v. Harvey*, 453 F.2d 722, 736 (2d Cir. *en banc* 1972); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. *en banc* 1968); *Coffee v. Permian Corp.*, 474 F.2d 1040 (5th Cir. 1973), *cert. denied*, 412 U.S. 920 (1973); and *Bailey v. Meister Brau, Inc.*, 535 F. 2d 982 (7th Cir. 1976).

On very similar facts, the Second Circuit *en banc* held in *Drachman v. Harvey, supra*, that §10(b) was violated by a misuse of corporate machinery in connection with securities transactions undertaken for the purpose of preventing a dilution of control. Under the compulsion of *Superintendent of Insurance v. Bankers' Life & Casualty Co., supra*, the Second Circuit *en banc* in *Drachman* at least implicitly overruled *Ryan*

[10] The application of § 10(b) to options of the type contained in Article VI of the Merrill Lynch charter is a recurring question because of the popularity of such restrictions, particularly in closely held corporations. See 2 *O'Neal, Close Corporations* § 7.09 (1971 ed.); *Bradley, Stock Transfer Restrictions and Buy-Sell Agreements*, 1971-72 Corporate Practice Commentator 154 (1972). Additionally, the same principles govern a variety of other corporate devices, including rights of first refusal, stock redemptions, liquidations and the issuance of new or additional shares.

v. J. Walter Thompson Co., supra, which was relied on heavily here by the majority of the Court of Appeals.

Contrary to the intimation contained in the Eighth Circuit majority opinion, here the vitality of the *Drachman-Schoenbaum* line of cases was not undermined or diminished in any way by this Court's decision in *Santa Fe Industries, Inc. v. Green, supra. Santa Fe* was *sui generis* in that it was the only case in which a claim had been held to be sufficient under Rule 10b-5 *without any allegation* of misrepresentation or manipulation. This Court's reversal was pegged on the holding that a fiduciary breach could not be actionable under the Rule "without any deception, misrepresentation, or nondisclosure." *Id.* at 476. In fact, the line of federal securities cases relied on by petitioners but discounted by the Eighth Circuit was expressly distinguished and excepted from the holding in *Santa Fe* by footnote 15 to that opinion, at page 475. The dispositive factors in *Santa Fe* were succinctly summarized in the concurring opinion of Mr. Justice Stevens, *l.c.* 481: ". . . (a) There was complete disclosure of the relevant facts, and (b) the minority are entitled to receive the value of their shares" through the appraisal process. Those are precisely the elements which are missing here and which bring this case within the scope of § 10(b).

This case represents rather graphically the precise type of abuse which the Securities Exchange Act of 1934 was designed to remedy. Referring to that Act and some of its sister legislation of the 1930's, this Court in *S.E.C. v. Captial Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963), said:

> "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."

Foremost among the evils sought to be corrected by Rule 10b-5 is the misuse of inside information by those who are at the

helm of the corporate machine and thus privy to important confidences, prospects and non-public plans:

> "Thus anyone in possession of material inside information must either disclose it to the investing public or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. *en banc* 1968), *cert. denied*, 394 U.S. 976 (1969).

It would be difficult to conceive of a more flagrant violation of these salutary rules than is depicted by the record in this case. Something went radically wrong with justice in the Court of Appeals, and respondents have been permitted to defy the principles which govern their industry. The Eighth Circuit appears to have read this Court's recent decisions as a substantial retreat from meaningful enforcement of the federal securities laws. The dubious legal principles which emerge from the opinion of the Eighth Circuit demand review by this Court.

II. The Court of Appeals Has Departed From Accepted Judicial Practice in Refusing to Apply Clearly Controlling and Well-Settled Principles of State Law and Has Erroneously Decided an Important Question of Law by Ruling That Respondents' Unfair Misuse of Corporate Machinery Did Not Constitute a Breach of Their Fiduciary Duties.

A. The Decision Below Is Contrary to Delaware Law.

The result reached by the majority opinion of the Court of Appeals constitutes nothing less than an abject refusal to apply the clearly defined law of Delaware, which all parties agreed was controlling in this diversity case, on the issue of whether re-

spondents breached their fiduciary duties to petitioners. The majority opinion disposed of that claim in two paragraphs, holding that there was no causal connection between petitioners' losses and any misrepresentation made by defendants. 562 F.2d at 1055. This ruling misapprehends the issue and completely ignores Delaware law, in contravention of *Erie Railroad v. Tomkins*, 304 U.S. 64 (1938).

The thrust of the claim for breach of fiduciary duty, as accurately characterized in Judge Heaney's dissent, was that respondents improperly used the corporate machinery (the Article VI call option) for their personal gain at the expense of, and with resulting damage to, the minority shareholders. Unlike the § 10(b) claim, this cause of action is not primarily rooted in misrepresentation and nondisclosure; it is more simply grounded in fundamental concepts of fair play and good faith. The Court of Appeals thus erred in holding that reliance was essential to plaintiffs' recovery under Delaware law and in summarily sweeping aside the numerous Delaware decisions imposing liability on corporate officers in far less aggravated circumstances.

Defendants unquestionably stood in a fiduciary relationship to plaintiffs. *Cohen v. Beneficial Loan Industrial Corporation*, 337 U.S. 541, 549 (1949); *Penn Mart Realty Co. v. Becker*, 298 A.2d 349 (Del. Ch. 1972); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769 (Del. Ch. 1967). A fiduciary's primary duty is to deal fairly and justly with his *cestius* and to exhibit the "utmost good faith and fair dealing." *Yasik v. Wachtel*, 17 A.2d 309, 313 (Del. Ch. 1941); *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975). The constraints imposed on a fiduciary were perhaps best summarized by Justice Douglas in his opinion for a unanimous Court in *Pepper v. Litton*, 308 U.S. 295, 311 (1939):

> "He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors

> *no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements.* For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestius*."

The law of Delaware—as elsewhere—has also long recognized that valid corporate machinery may not be employed for an improper motive or personal gain or manipulated so as to injure minority shareholders. *Condec Corp. v. Lunkenheimer Co., supra; Yasik v. Wachtel, supra; Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236 (Del. Ch. 1953); *Bodell v. General Gas and Electric Corporation*, 140 Atl. 264 (Del. 1927). In *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437, 439 (Del. 1971), Delaware Supreme Court said:

> ". . . inequitable action does not become permissible simply because it is legally possible."

The federal court in *Voege v. American Sumatra Tobacco Corporation*, 241 F.Supp. 369 (D. Del. 1965), ruled that a corporate merger, otherwise perfectly legal under Delaware law and authorized by the governing Articles of Incorporation, could not be consummated where the result would be to deprive the plaintiff minority shareholder of the value of her shares. The court rejected the corporation's reliance upon its "contract" rights to effectuate the merger and ruled that the plaintiff's apparent acquiescence in the terms of that contract did not prevent her from challenging an unfair *exercise* of the corporate powers.

The cases of *Yasik v. Wachtel, supra* at 313, and *Condec Corp. v. Lunkenheimer Co., supra* at 775, both held that corporate insiders could not "make use of the issuance of shares to accomplish an improper purpose, such as to enable a particular person or group to maintain or obtain voting control."

Even though the defendants had a "contract right" under their charter to issue new shares, the courts refused to wink at the obvious fiduciary abuses which would inhere in the proposed exploitation of that "right."

The leading case of *Speed v. Transamerica Corporation*, 99 F.Supp. 808, 849 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956), also dealt with a situation closely akin to that presented here. The parent corporation devised a plan whereby the subsidiary was to be liquidated in order to realize the value of the undisclosed appreciation of the subsidiary's tobacco inventory. Pursuant to that plan, and in perfect conformity with the powers contained in the subsidiary's corporate charter, the parent initiated a call of the Class A common stock of the subsidiary without disclosing the impending liquidation. The district court had no trouble finding liability under those circumstances, *l.c.* 849:

> "Defendant, by reason of its control over the board of directors of [the subsidiary], was under a fiduciary obligation to the minority shareholders of [the subsidiary] to act with fairness towards them, *and in causing the directors of [the subsidiary] to call the class A common stock for redemption on April 30, 1943, defendant violated its fiduciary obligations* to all the class A common stockholders."

The court in *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975), enjoined a contractually authorized redemption of preferred stock where it appeared that the purpose of the redemption was to enable management to maintain control:

> "Clearly directors of a corporation stand in a position of trustees with the stockholders . . ., and the utmost good faith and fair dealing are required of them, especially where their individual interests are concerned. *Moreover, the fact that charter or by-law provisions may technically permit*

> *the action contemplated does not automatically insulate director against scrutiny of purpose."*[11]

Faced with these overwhelming and unwavering Delaware authorities, the majority opinion summarily branded them as distinguishable (which they most emphatically are *not*) but cited no authority from *any* state in support of its contrary conclusion.[12] The only justification mustered by the majority was a *"Cf."* citation, 562 F.2d 1055, n. 23, to the Delaware Chancery Court opinion in *Singer v. Magnavox Co.*, 367 A.2d 1349 (Del. Ch. 1976). However, less than a month after the Eighth Circuit's opinion was filed, the Delaware Supreme Court reversed *Singer*, reaffirmed the cases relied on above by petitioners, and again reiterated the elementary proposition that "corporate machinery may not be manipulated so as to injure minority stockholders." *Singer v. Magnavox Co.*, — A.2d — (Del. Sept. 23, 1977). The Delaware Supreme Court totally rejected the rationale of the Eighth Circuit in this case and held that "entire fairness" was the overriding concern of the Delaware Corporation Code.

Nevertheless, even though the Supreme Court's *Singer* decision was brought to the attention of the Eighth Circuit, it refused to grant a rehearing and did not even bother to amend its opinion to delete its reliance on a decision which had since been reversed.

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[11] The availability of preliminary injunctive relief to prohibit consummation of unfair transactions in cases such as *Petty* and *Schnell, supra*, constitutes a complete and unassailable refutation of the Eighth Circuit's materiality ruling.

[12] The majority opinion also erred in isolating November 18 as the only critical date for analyzing defendants' duties and in holding that everything occurring subsequent to that date was irrelevant (562 F.2d at 1044, n. 7). Although the "call" was issued on that date, the duties were still extant until at least the first part of 1971 when plaintiffs were paid for their stock and ceased to be shareholders. The Eighth Circuit's holding in this regard is squarely contrary to *Ohashi v. Verit Industries*, 536 F.2d 849 (9th Cir. 1976), *cert. denied*, 429 U.S. 1004 (1976).

Such defiance of controlling precedent is utterly mystifying and presents a fundamental question about the power of federal courts in diversity cases to reshape state law to suit their preferences:

> "A federal court in a diversity case is not free to engraft onto those state rules exceptions or modifications which may commend themselves to the federal court, but which have not commended themselves to the State . . ." *Day & Zimmerman, Inc. v. Challoner*, 423 U.S. 3, 4 (1975).

B. The Fiduciary Issue Is of Substantial Significance in Regulating the Rights and Obligations as Between Corporate Insiders and Outsiders.

The significance of the fiduciary issue in this case extends beyond its profound impact on the parties and on the many other Merrill Lynch ex-stockholders who have similar claims aggregating tens of millions of dollars. The fiduciary aspects of this case are controlled by the law of Delaware, where more American corporations are chartered than any other state. Decisions on Delaware Corporation Law often set the tone for rulings in many other jurisdictions which have patterned their statutes after Delaware and/or which look to Delaware as the trend-setter. Hence, the principles espoused by the Eighth Circuit majority are not at all parochial but will have considerable impact upon the operations of thousands of corporations and the rights of millions of shareholders.[13]

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[13] As many as 9000 new companies incorporate in Delaware each year. *Cary, Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 668 (1974). Many of these are closely held corporations, but a sizable number of major firms also are Delaware citizens:

> "Moreover, a substantial and growing fraction of the major corporations is organized in Delaware. Of the approximately 1,250 concerns listed on the New York Stock Exchange in 1965, 433 or 35 percent were Delaware corporations. And the percentage is growing. As of January 5, 1973, there were 1,505 listed companies, of which 606 or 40 percent were organized in Delaware. For this reason alone Delaware decisions have a profound impact upon the development of corporation law. Furthermore, similar to its influence on statutory modernization, Delaware's case law is cited constantly and relied upon in other jurisdictions." *Id.* at 671.

The Court of Appeals' pronouncement that "anything goes if the charter permits it" has broad implications in a wide range of varying factual settings. The ruling below signals a return to the "morals of the marketplace" as the standard for fiduciary conduct and is certain to be roundly criticized by legal scholars and commentators. It is squarely at odds with the principles established by this Court in *Strong v. Repide*, 213 U.S. 419 (1909), and *Pepper v. Litton, supra*, and disregards the statement in *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, 85 (1943):

> "We reject a lax view of fiduciary obligations and insist upon their scrupulous observance."

Far from presenting an esoteric question of state law, this case poses a fundamental and far-reaching issue concerning the relative rights and obligations of corporate insiders *vis-a-vis* outsiders. The decision below has seriously unbalanced the scales and should be reviewed by this Court.

CONCLUSION

For the reasons stated, a Writ of Certiorari should issue to review the opinion and judgment of the Court of Appeals.

Respectfully submitted,

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January 1978

APPENDIX

APPENDIX A

In the United States District Court
Eastern District of Missouri
Eastern Division

St. Louis Union Trust Company, et al.,
Plaintiffs,

v.

Merrill Lynch, Pierce, Fenner & Smith, et al.,
Defendants.

No. 73 C 373(1)

FINDINGS OF FACT AND CONCLUSIONS OF LAW

(Filed in U. S. District Court March 24, 1976)

This matter was tried to the Court without a jury. The Court has been duly informed by briefs, exhibits, depositions, and testimony.

Findings of Fact

1. Plaintiffs are the executors of the estate of Kenneth H. Bitting, deceased, and all are citizens of the State of Missouri.

2. Defendant Merrill Lynch, Pierce, Fenner & Smith, Incorporated, (Merrill Lynch), is a corporation organized under the laws of the State of Delaware, with its principal place of business in New York City. It was incorporated on November 7, 1958. Prior to that time it had been a partnership. The defendant Donald T. Regan was president and a director of Merrill Lynch during 1970 and became chairman of the Board of Di-

rectors on January 1, 1971. George L. Shinn was vice-chairman of the Board of Merrill Lynch and was in charge of planning in 1970. Ned B. Ball was a senior vice-president and a director of Merrill Lynch in 1970 and president in 1971. None of the individual defendants were residents of the State of Missouri at any time relevant to this suit.

3. Pursuant to the terms of Kenneth H. Bitting's last will and testament, the 40,000 shares of Merrill Lynch non-voting common stock owned by him at the time of his death were to become the corpus of the Kenneth H. Bitting revocable trust. The beneficiaries of that trust are the four Bitting children, Kenneth, Jr., William, George, and Barbara B. Fraser, and the deceased's wife, Esther C. Bitting.

4. Merrill Lynch is the largest firm in the securities industry. Its assets exceed three billion dollars. It has over 1,500,000 customers, 5,600 registered representatives, and 245 branch offices in the United States and several foreign countries, and employs over 20,000 people.

5. In 1947, Kenneth H. Bitting was a stockholder in the City of St. Louis, Missouri. His partnership merged into and became the St. Louis office of Merrill Lynch. Bitting became an employee of the Merrill Lynch partnership and was in charge of its St. Louis office. He became a general partner in Merrill Lynch in 1951.

6(a) When Merrill Lynch was incorporated in November of 1958, Kenneth H. Bitting received 9,100 shares of the corporation's voting common stock and a debenture in the amount of $58,000 in exchange for his partnership capital of $240,000.

(b) On October 30, 1959, Merrill Lynch split its common stock on a basis of three for one. Bitting's holding increased to 27,300 shares. In December 1962, Bitting retired. Upon retirement, under the provisions of the corporate charter, he sold

his voting stock to the corporation, and received 10,000 shares of non-voting common stock and $423,642.40, representing the net book value of 17,300 shares as of December 28, 1962.

(c) On July 6, 1966, and on January 15, 1969, Merrill Lynch split its common stock on a two-for-one basis, resulting in Bitting's holdings having increased to 40,000 shares of non-voting common stock at the time of his death on October 8, 1970. The cost basis of this stock was $66,700.

7. Pursuant to Rule 313.21 of the New York Stock Exchange, the certificate of incorporation of Merrill Lynch contained provisions in Article VI, section (1)(a), granting the corporation the first right and option to purchase within a ninety-day period a stockholder's shares in certain events, including the death of the stockholder. In addition, subsection (1)(g) authorized a call whenever the Board of Directors determined, and a majority of the shareholders of voting stock agreed, that it was necessary for the welfare of the corporation. Subsection (10) required approval of any transferee by the exchanges, boards of trade, and similar institutions to which the corporation belongs, when such approval is a condition of the corporation's membership, and also triggered a new ninety-day option period if the holder could not secure an approved transferee within the original ninety-day period. The certificates of stock issued by Merrill Lynch provided that the owner, by accepting the certificate, expressly assented to the provisions of the certificate of incorporation.

8. The purpose of having two classes of common stock, voting and non-voting, was to comply with the rules of the New York Stock Exchange then in force, which limited the ownership of voting stock to persons who were full-time officers or employees of member firms. The rules of the New York Stock Exchange further required that approval be obtained from that Exchange when stock of member firms, which was restricted, was transferred to other persons.

9. After Bitting's death, Merrill Lynch exercised its option to purchase his 40,000 shares of non-voting common stock on November 18, 1970, and paid the estate $26.597 per share, the net book value, for a total sum of $1,063,880 on December 30, 1970. At the same time, it permitted his widow to purchase 10,000 shares at a price of $26.597 per share. She was one of eleven other widows of Merrill Lynch stockholders who was permitted to acquire non-voting common stock at the death of her husband.

10. Merrill Lynch normally purchased all a partner's voting common stock when the partner retired and permitted him to purchase forty percent of that amount in non-voting stock. Merrill Lynch usually purchased all the non-voting stock when the stockholder died, however, there were some exceptions made to this policy to take care of individual stockholders. The options to purchase the voting stock of Winthrop C. Smith and E. A. Pierce were not exercised when these two men became incapacitated and for all practical purposes retired. When Smith died in 1961, the corporation's option to purchase his stock was not fully exercised and some of the shares were transferred to a trust. The option to purchase Pierce's stock when he retired was not exercised, instead Merrill Lynch amended its certificate of incorporation to permit Pierce to own a class of preferred stock in exchange for his common. In the case of stock owned by the Charles E. Merrill trust, Merrill Lynch entered into a contract with the trust permitting the stock to be sold each year over a period of ten years, the last year being in 1976, and Merrill Lynch did not purchase that portion of the stock it was to purchase in the year 1971. Since the stock in the Charles E. Merrill trust had all the restrictions removed when Merrill Lynch went public on June 23, 1971, it did not fulfill these purchases, and the trust benefited accordingly. Upon the deaths of Francis D. Willis and Edward E. Bartlett, Jr., some of their stock went into trusts. The estates of James Dwyer, Austin

Graham, and Joseph C. Quinn were permitted to retain some of their stock when those stockholders died. Those cases in which the option was not uniformly exercised, either at retirement or death, were to benefit the individual partner or his family. This leads the Court to the inescapable conclusion that the corporation had no uniform policy in exercising the options to purchase stock at retirement or death of a stockholder.

11. James E. Thompson, chairman of the Board of Merrill Lynch, retired on December 31, 1970, owning 130,000 shares of voting common stock. Merrill Lynch paid cash to Thompson for the net book value of 78,000 shares and permitted him to exchange 52,000 shares of voting common stock for non-voting common stock, which he retained. He would not have retired had he known Merrill Lynch was going public in June 1971, and was shocked when he learned the news in 1971.

12. Darwin Fenner, Kenneth W. Martin, and James D. Corbett were all directors and officers of Merrill Lynch in 1970. Fenner owned 325,000 shares of voting common stock, Martin owned 122,000 shares, and Corbett owned 75,600 shares. Upon their retirement on December 31, 1970, Merrill Lynch paid cash for the net book value of sixty percent of said shares and permitted a share-for-share exchange of its non-voting common stock for the remaining forty percent. Fenner was assured by Donald T. Regan in December 1970 that Merrill Lynch was not going public any time in the near future.

13. Donald T. Regan did not acquire any voting or non-voting common stock after 1960. George Shinn's last acquisition of stock, 1,000 shares, was in May 1970.

14. The restrictions on the stock served a valid purpose at the time Merrill Lynch was incorporated in 1958. That purpose was to comply with the rules of the New York Stock Exchange. Merrill Lynch was advised by counsel that these restrictions served a valid purpose and were binding at that time.

15. The Board of Directors of Merrill Lynch from the time of its incorporation through 1970 were all employees of Merrill Lynch. They had worked up the ladder through the firm. Management consisted of a very small group of from three to five people who made the decisions for the corporation. The chairman of the board determined when a stockholder could increase his holdings by additional purchases of stock. The chairman of the Board and the president determined when stockholders could advance from a non-voting status to a voting status. The chairman of the Board or the president determined whether the restrictions contained in Article VI of the Articles of Incorporation would be enforced in any given situation. The chairman of the Board and the president determined the composition of the Board of Directors.

16. In June 1969, the brokerage firm of Donaldson, Lufkin and Jenrette, a member of the New York Stock Exchange, announced that it would make a public offer of its securities. By so doing, this firm challenged the New York Stock Exchange rules prohibiting public ownership of member firms.

17. Merrill Lynch had long advocated public ownership of brokerage firms who were members of the New York Stock Exchange. Donald T. Regan was a member of the New York Stock Exchange Committee on Permissive Public Ownership of member firms. After the announcement by Donaldson that it was going public, the New York Stock Exchange committee quickly went to work and was asked to report its recommendations to the Board of Governors of the New York Stock Exchange for its July 17, 1969, meeting.

18. Along with these developments on the New York Stock Exchange, Regan requested Merrill Lynch's Corporate Planning Department to prepare a study on Merrill Lynch and public ownership. One problem with which Regan was concerned, if Merrill Lynch went public, was control of the company.

19. On September 8, 1969, the New York Stock Exchange Committee on Permissive Public Ownership issued its text of proposed constitutional amendments providing for public financing of member corporations. On September 18, 1969, the Board of Governors adopted the proposed amendments in principle. On February 12, 1970, the New York Stock Exchange Board of Governors announced that it had approved the proposed changes and on March 26, 1970, the proposed constitutional changes and rule changes were made, which permitted freely transferable securities to be held by member firms.

20. On February 19, 1970, Regan appointed a committee to study public ownership of Merrill Lynch under the direction of George L. Shinn, who was a director of Merrill Lynch and a member of the Executive Committee. At a March 12, 1970, meeting of the study committee to go public, Shinn coined the phrase "twilight zone." By this phrase he meant the period between the date when the board decision to go public was made and the date when that decision became fully effectuated. One of the items the committee discussed was Merrill Lynch's legal responsibility to stockholders during the twilight zone. The committee concluded that further legal advice should be sought on Merrill Lynch's legal responsibility to its stockholders during that time. The record in this case is devoid of any opinions from counsel to Merrill Lynch, to its Board of Directors, to its officers, or anyone else concerning these legal responsibilities.

21. On March 16, 1970, Ross Kenzie, a committee member, wrote Shinn that there should be modifications of the restrictions on stock transfer after the decision to go public, but prior to the execution of that decision. On March 19, 1970, W. Eugene Cartwright wrote Shinn that there was a possible moral and lega! responsibility to the estates of stockholders who die or retire during the twilight zone and that advice of counsel should be sought on the matter.

22. The final report of the study committee on going public was issued on April 3, 1970. This committee unanimously recommended that Merrill Lynch go public and they thought a reasonable target date for the achievement of public ownership would be May 1, 1971.

23. One of the major conclusions of the study committee report, and a concern of defendants throughout the twilight zone, was the necessity of increasing the per share earnings of Merrill Lynch stock.

24. Shinn at no time communicated to the Board of Directors the question of potential legal responsibilities to stockholders during the twilight zone period. This was not discussed at any Executive Committee or Board of Directors meeting during 1970 and 1971. Shinn cautioned the members of his Study Committee not to discuss going public with anyone, except other committee members. On April 6, 1970, Shinn recommended to Merrill Lynch's Policy Committee that Robert Trone be appointed as the man to spearhead and coordinate the public ownership effort. Trone had fifteen years experience in the underwriting business and had worked on over one hundred public offerings. Trone's assignment was to be completed by July 14, 1970. He was to look into the question of Merrill Lynch going public from an underwriter's point of view.

25. On April 14, 1970, Merrill Lynch held its annual stockholders meeting. Regan did not advise tthe stockholders that management had appointed a committee to study the question of public ownership. Nor did he advise them of the conclusions which that committee had reached.

26. On May 1, 1970, the Merrill trust by Henry Happel, a senior partner of tthe Brown, Wood law firm and secretary of the trust, postponed its scheduled 1970 sale of 34,344 shares of stock to Merrill Lynch until 1971.

27. On June 29, 1970, Trone submitted his report on the mechanics of going public to Shinn and called for a public offering in March of 1971. This report included strategy to prevent possible take-over bids or interference with management by large stockholders. Trone did not report his conclusions to the Board of Directors nor to the chairman of the Board of Directors, James E. Thompson. In June of 1970 it was generally known at Merrill Lynch that Thompson, the chairman of the Board, planned to retire in December 1970. Also it was generally known that Regan would succeed Thompson as chairman of the Board.

28. On July 6, 1970, Shinn recommended to Merrill Lynch's Executive Committee that it approve the creation of a task force to conduct an internal audit of the firm to advance the investigation of public ownership possibilities. On July 14, 1970, the Board of Directors approved the formation of a legal and accounting task force to conduct an audit of the firm's business and structure in preparation for public ownership at some time in the future and to improve the operations of the business. The Board of Directors was not informed on July 14, 1970, that this task force, which it created for possible future public ownership, did, in fact, take all steps necessary to actually have public ownership effectuated by the spring of 1971. Between July 1970 and April 1971, the task force was given no authority by the Board of Directors or the Executive Committee to employ outside auditors or to draft a registration statement. It did in fact, however, hire Haskins & Sells on July 31, 1970, to prepare financial statements and ten-year audits for inclusion in a registration statement. Attorneys were employed to draft a prospectus.

29. Merrill Lynch's Executive Committee met on a weekly basis from July 14, 1970, through April 7, 1971, however, neither Shinn nor Regan reported to the Executive Committee of the task force timetable for going public. Between May and July 14, 1970, the Dow-Jones average had risen approximately

one hundred points. It rose another one hundred points between July and December 1970.

30. On October 13, 1970, Merrill Lynch's Board of Directors held its regular meeting. George Shinn reported to the Board that the task force on public ownership was progressing, but he did not advise the Board that the outside auditors expected to complete the audit of the company by December 1970, nor did he report that the task force had consulted Merrill Lynch's lawyers, the Brown, Wood firm, to discuss the contents of a prospectus. Neither did Regan nor Ball report this to the Board, yet both were aware of the activities of the task force. At this meeting, Donald T. Regan was elected the next chairman of the Board and Ned B. Ball was elected the next president of Merrill Lynch to take office as of January 1, 1971.

31. On October 28, 1970, Merrill Lynch's Board of Directors, under prodding from the New York Stock Exchange, voted to acquire Goodbody & Co. Goodbody was failing and Merrill Lynch took them over. This acquisition slowed to some extent the time table for the public offering. However, on November 5, 1970, Haskins & Sells was engaged to audit Goodbody & Co., which was a necessary step to going public.

32. On November 18, 1970, Howard Sprow and Joseph Maiorca of Merrill Lynch and Ed Lill of Haskins & Sells met with the staff of the Securities and Exchange Commission to discuss the financial statements to be contained in the Merrill Lynch prospectus. The purpose of this meeting was to persuade the SEC to classify Goodbody & Co. as a non-significant subsidiary, so that separate financial statements for Goodbody would not have to appear in Merrill Lynch's prospectus. Regan was aware of this meeting with the SEC, however, Thompson, the chairman of the Board, had no knowledge of this meeting.

33. On the same day that the meeting was held with the SEC, November 18, 1970, Merrill Lynch notified plaintiffs by tele-

phone and letter that it was enforcing the restrictions contained in Article VI to purchase the 40,000 shares of Merrill Lynch stock. Had the plaintiffs been aware at this time of the plans to go public in the spring of 1971, they would have resisted vigorously the sale of their stock to Merrill Lynch.

34. On October 30, 1970, Merrill Lynch held an aggregate of 6,323,584 shares of its stock in its treasury. It also had 4,835,100 authorized but unissued shares of common stock. On November 18, 1970, there was no legitimate business purpose for the enforcement of the restriction in Article VI of the Articles of Incorporation. There was no reason to purchase the plaintiffs' stock, except to reduce the number of shares outstanding in order to improve the price for the forthcoming public offering. On December 8, 1970, the Board of Directors increased the semiannual dividend from fifty cents to sixty-five cents per share. This was another twilight zone activity to increase the value of the stock at public offering.

35. On December 11, 1970, Haskins & Sells commenced its audit of Goodbody and agreed to have it completed within sixty days. It actually took about ninety days. On December 18, 1970, the task force met with Shinn. Their timetable called for a meeting with Brown, Wood on December 21, 1970, to review the first draft of the registration statement to be filed with the SEC on March 1, 1971, and to become effective on March 24, 1971.

36. On December 30, 1970, the task force on going public met with Chairman Regan, President Ball, Vice-chairman Shinn, General Counsel Sprow, Frady, and Spies. At this meeting Regan decided that the public offering would be 4,000,000 shares, 2,000,000 to be sold by the company, and 2,000,000 to be sold by stockholders; that a stockholder could sell no more than ten percent of his holdings; that the stock would be split three for one prior to the public offering. Prices

of $28.00 to $30.00 per share were discussed as the price for the public offering after the three-for-one split. It was decided to submit the public ownership decision to the Board of Directors meeting in March 1971 for ratification and that the registration statement could be filed in the latter part of April 1971. This meeting also discussed an effort to get the National Association of Securities Dealers to permit a change in policy so that Merrill Lynch could sell its own stock.

37. On December 30, 1970, Merrill Lynch mailed its check for $1,063,880 to the plaintiffs for the purchase of their 40,000 shares of non-voting common stock.

38. On January 21, 1971, the National Association of Securities Dealers' Board of Directors informally accepted the policy to permit self-underwriting.

39. On February 2, 1971, Haskins & Sells advised Merrill Lynch that the Goodbody audit would not be completed on February 11, 1971, as promised but promised to deliver it on March 15, 1971. Regan then decided that the three-for-one stock split would not be submitted to the regular March 9, 1971, meeting of the Board of Directors, as previously scheduled.

40. In February 1971, Charles Dougherty, an old friend of Regan's, was advised by Regan that he could keep his 6,000 shares of non-voting stock after his retirement on April 1, 1971.

41. On February 18, 1971, Brown, Wood submitted an application to the Internal Revenue Service requesting a ruling on the tax consequences of removing the restrictions on the transfer of Merrill Lynch stock. The application stated that management had decided that Merrill Lynch needed additional capital; that a registration statement and prospects would be filed with the SEC around May 1, 1971; that the total price

of the offering would be around $50,000,000; that the sole purpose of the restrictions in Article VI of the Articles of Incorporation was to comply with the New York Stock Exchange regulations and these restrictions were about to be removed in light of the public offering.

42. In November 1970, Ball purchased 1,000 shares of Merrill Lynch stock and in February 1971 another 3,000 shares. During Feb. 1971 General Counsel Sprow purchased 5,000 shares, and task force member Spies purchased 1,000. All of this stock was purchased at book value and tripled in value on June 23, 1971, when the public offering was made.

43. On March 9, 1971, Regan reported to the Merrill Lynch Board of Directors that the firm had made no plans with respect to the public offering of the company stock. He has stated his reason for this was to protect them from the consequence of having this advance knowledge.

44. On March 12, 1971, Haskins & Sells submitted a draft report of its Goodbody audit to Merrill Lynch. On that same day, Regan, Shinn, and Ball decided that all the preparations for the public offering were completed and the company was ready to file its registration statement. The defendants contend that this is the date on which management's decision to go public was made. This Court finds that the decision to go public was made by management on July 14, 1970. This decision included a target date for the spring of 1971, even though the date was delayed because of the Goodbody acquisition, and the going public was accomplished on June 23, 1971.

45. On April 7, 1971, Shinn reported to the Executive Committee that Merrill Lynch was ready to go public and recommended its approval by the Board of Directors. This was the first time that the Executive Committee of the Board was advised of this decision.

46. On April 8, 1971, the Board of Directors approved the decision to go public and also approved the necessary amendments to the Merrill Lynch Certificate of Incorporation, removing the restrictions. The Board also approved a stock option plan for employees. On April 9, 1971, the Board further decided not to enforce the restrictions to purchase stockholders' stock on death or retirement from that day forward, resulting in the following actions:

a. April 9, 1971, Albert G. Boesel, holding 1,600 pre-split non-voting shares died. Merrill Lynch did not exercise its option to purchase his stock.

b. April 15, 1971, Harry B. Anderson, a director of Merrill Lynch, transferred beneficial ownership in several hundred shares of Merrill Lynch voting stock to his five children.

c. On May 23, 1971, Walter B. Honsberger, a retired employee of Merrill Lynch, holding 6,400 pre-split non-voting shares of stock, died. The corporation did not exercise its option to purchase his stock.

d. On May 28, 1971, Theodore Weincoff, a retired Merrill Lynch employee, holding 4,000 pre-split shares of non-voting stock, died. Merrill Lynch did not exercise its option to purchase his stock.

e. On June 13, 1971, Byron G. Webster, a retired Merrill Lynch employee, holding 29,000 pre-split shares of non-voting stock, died. The corporation did not exercise its option to purchase this stock.

47. On April 12, 1971, Merrill Lynch publicly announced it intended to file a registration statement with the SEC and go public. This was approved by the stockholders of Merrill Lynch on April 20, 1971, who approved the necessary amendments to the Certificate of Incorporation.

48. On April 23, 1971, Merrill Lynch filed its registration statement with the SEC, stating the maximum offering price was expected to be about $35.00 per share.

49. On May 8, 1971, the National Association of Securities Dealers mailed to its members a proposed rule to permit self-underwriting.

50. In early May 1971, Merrill Lynch retained First Boston Corporation, Morgan Stanley, and Lehman Brothers to appraise the corporation stock and recommend a public offering price.

51. On June 23, 1971, Merrill Lynch went public, the stock was split three for one and reclassified as voting stock. All restrictions were removed. The total offer was 4,000,000 shares, 2,000,000 by the corporation and 2,000,000 by the shareholders. The offering price was $28.00.

52. Between July 14, 1970, and April 9, 1971, Merrill Lynch reduced the number of its outstanding shares by approximately 670,000 by exercising its options to purchase shares of stock of retired employees and those who had died. This number of shares became approximately 2,000,000 shares when the three-for-one split became effective, and were sold to the public for $28.00. The 2,000,000 shares cost the corporation approximately $9.00 per share. These were sold for $28.00 per share to the public, making a net gain of $19.00 per share, or approximately $38,000,000, which the corporation realized as a result of exercising its options after the decision to go public was made and before it was announced.

53. Of the public offering of Merrill Lynch stock, 400,000 shares was reserved for and purchased by its employees.

54. On June 23, 1971, Regan owned 288,000 shares of Merrill Lynch stock, with a market value of $8,000,000. His

annual compensation for the previous year was $209,000. On that date Shinn owned 63,000 shares of Merrill Lynch stock, with a market value of about $1,760,000. His annual compensation for the previous year was $134,000. On that same date, Ball owned 150,000 shares of Merrill Lynch stock, with a market value of $4,200,000. His annual compensation for the previous year was $108,000.

55. On July 12, 1971, Shinn wrote an article appearing in Merrill Lynch's in-house newspaper that the corporate decision to go public was made at the Board of Directors' meeting on July 14, 1970. Shinn prepared the statement appearing in the article in response to written questions submitted to him by the newspaper's editor. Shinn reviewed a draft of the article for accuracy prior to publication. His answers were reviewed by the legal department of Merrill Lynch prior to publication.

56. On August 23, 1971, in an article in the in-house journal of Merrill Lynch "We The People", Frady in an interview, stated that management made the decision to go public on July 14, 1970, with a goal of having a public offering in the spring of 1971. Frady reviewed this article prior to publication; it was reviewed by Merrill Lynch's legal department prior to publication.

57. Plaintiffs first learned about these two July and August articles during the fall or winter of 1971.

Conclusions of Law

1. This Court has jurisdiction of the parties and the subject matter of this action based on the diversity of citizenship of the parties and based on section 27 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78aa (1971), and pendent jurisdiction over state claims which derive from the same facts as the federal claim.

2. The claims presented to this Court for determination are plaintiffs' claims of common law fraud and breach of fiduciary duty, and violations of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5, promulgated thereunder, against Merrill Lynch and the individual defendants for damages plaintiffs sustained from the fraudulent purchase of their 40,000 shares of Merrill Lynch stock by the corporation.

3. Plaintiffs' claims are not barred by the applicable federal, Missouri, and Delaware statutes of limitations. A cause of action under section 10(b) and Rule 10b-5 does not accrue until the fraud is or should be discovered. *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir. 1970), cert. denied, 400 U.S. 852 (1970). Since plaintiffs did not learn and were not put on notice that the November 18, 1970, call was fraudulent until the publication of the articles in the July 12 and August 23, 1971, issues of the Merrill Lynch house organ, the action did not accrue until July 12, 1971. The complaint was timely filed on June 6, 1973. See *Vanderboom v. Sexton*, supra [statute of limitations for 10b-5 claim is analogous state blue-sky statute, two years under section 409.411, R.S.Mo. (1967)]. The action is clearly within the five-year limitations period for common law fraud under section 516.120, R.S.Mo. (1949), and the three-year limitations period for breach of fiduciary duty under Del. Code Ann., Title 10, § 8106 (1970). See *Bokat v. Getty Oil Co.*, 262 A.2d 246 (Del. 1970).

4. **Rule 10b-5**

(a) Rule 10b-5 of the Securities and Exchange Commission provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

(b) The nondisclosure of material inside information in connection with the purchase or sale of securities, constitutes a violation of Rule 10b-5. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

> ". . . material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities." *Texas Gulf Sulphur*, 401 F.2d at 849.

Whether or not information is material ". . . will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." Id.

(c) The evidence establishes that months prior to the purchase of plaintiffs' stock, defendants were firmly committed to a public offering, any remaining contingencies, including the Goodbody takeover, affecting only the timing of the offering.

Certainly the decision of the largest brokerage company in the country to go public was information which would have a significant impact on the future of the corporation, and on the investment decisions of potential purchasers and sellers of its securities. The former chairman of the Board, who was not informed of the pending offering, testified that he would not have retired, thus subjecting his stock to the call option, had he known of the imminence of the offering. That the offering would have a significant effect on the price of the stock is reflected in the evidence which shows that at the time plaintiffs' stock was purchased, defendants contemplated a three-fold increase in the price of the stock.

(d) The nondisclosure was part of a scheme to maintain management control and to increase the per share earnings of Merrill Lynch stock prior to a public offering at the expense of plaintiffs and other non-employee shareholders. A means of accomplishing these purposes lay near at hand: exercising the corporation's option to call the stock of shareholders who had left the employ of Merrill Lynch through termination, retirement, or death. The option was exercised pursuant to a stock transfer restriction which by its own terms was to be exercised solely for the purpose of complying with the rules of the New York Stock Exchange regulating privately-held member brokerage houses.

(e) Defendants argue that they are protected from liability under Rule 10b-5, and from common law tort liability, because they had an absolute contractual right, under Article VI of the Certificate of Incorporation, to exercise the call option. The validity of the stock transfer restriction which Merrill Lynch exercised in calling plaintiffs' stock must be determined under Delaware law. *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, 490 F.2d 818, 821 (5th Cir. 1974); 2 Restatement (Second) on Conflict of Laws § 303 (1971). Section 202 of the Delaware General Corporation Law of 1967, Del.Code Ann., Title 8,

§ 202 (1967), governing restrictions on the transfer of securities, reads in pertinent part:

"(a) A written restriction on the transfer or registration of transfer of a security of a corporation, if permitted by this section and noted conspicuously on the security, may be enforced against the holder of the restricted security or any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder.

". . .

"(c) A restriction on the transfer of securities of a corporation is permitted by this section if it;

"(1) Obligates the holder of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire restricted securities, or

"(2) Obligates the corporation or any holder of securities of the corporation or any other person or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities; or

"(3) Requires the corporation or the holders of any class of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities; or

"(4) Prohibits the transfer of the restricted securities to designated persons or classes of persons, and such designation is not manifestly unreasonable.

"(d) Any restriction on the transfer of the shares of a corporation for the purpose of maintaining its status as an

electing small business corporation under subchapter S of the United States Internal Revenue Code is conclusively presumed to be for a reasonable purpose.

"(e) Any other lawful restriction on transfer or registration of transfer of securities is permitted by this section."

(f) A restriction falling within the section 202(e) catchall provision must meet the standards of reasonableness developed in Delaware case law, while a restriction expressly permitted by any of the four subsection (c) categories is arguably per se validated. E. L. Folk, III, The Delaware General Corporation Law: A Commentary and Analysis, 200 (1972); Comment, Section 202 of the Delaware General Corporation Law: Per Se Rules for Stock Transfer Restrictions, 9 B.C.Inc. & Com.L. Rev., 405, 411 (1968). The challenged restriction does not fall within subsection (c) since that subsection applies only to voluntary transfers, not transfers by operation of law as here. Comment, supra, at 414. Cf. *In re Riggs v. Midwest Steel & Iron Works*, 540 P.2d 361 (Colo.App. 1975); *Globe Slicing Machine Co. v. Hasner*, 333 F.2d 413 (2d Cir. 1964), cert. denied 379 U.S. 969 (1965).

(g) Moreover, Article VI, which in subsection (1)(a) authorizes a call upon the death of a holder of common stock, contains further restrictions: the triggering of additional ninety-day option periods whenever necessary for the welfare of the corporation and whenever an approved transferee cannot be found within the original ninety day period, and the requirement of the New York Stock Exchange approval for all proposed transferees. These additional restrictions must be considered in determining the statutory classification of the option.

(h) Even assuming the restriction were per se legal under subsection (c)(1), it would be invalid if exercised for a fraudulent purpose. *Green v. Santa Fe Industries, Inc.*, No. 75-7256 (2d Cir. February 18, 1976) (short form merger legal under

Delaware law violation of Rule 10b-5 where consummated without any justifiable corporate purpose and to the detriment of minority stockholders); *Bryan v. Brock & Blevins Co., Inc.*, 343 F.Supp. 1062 (N.D.Ga. 1972), aff'd on other grounds, 490 F. 2d 563 (5th Cir. 1974), cert. denied, 419 U.S. 844 (1974), (short form merger legal under Georgia law and justified on alleged policy of "active employee" ownership, a policy the court found nonexistent, held violation of Rule 10b-5 where defendants failed to disclose plans for going public and where sole purpose of merger was to freeze out the minority shareholder.)

(i) Defendants stress the argument that the option was a binding contractual obligation, regardless of the purpose for which it was exercised and regardless of what information was available to plaintiffs. In another merger case, *Voege v. American Sumatra Tobacco Corp.*, 241 F.Supp. 369 (D.Del. 1965), the Court noted that the Delaware merger statute constituted a part of the charter of the corporation and as such a contract between the corporation and its shareholders, giving rise to an option to purchase upon merger. The Court held, however, that plaintiff stated a claim by her allegations that the merger, which, under Delaware law needed no justification, was undertaken for the sole purpose of defrauding plaintiff and other minority shareholders. "Every contract contains the implied condition that the parties to it will act in good faith and deal fairly with each other in its performance." Id. at 375. In *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972), the Court, in rehearing en banc, invalidated a technically legal call on debentures where the call was exercised for the improper purpose of cementing the control of the majority shareholder by eliminating the possibility that the debenture holders would exercise their right to convert to common stock. This decision overturned an earlier panel's decision that the call was valid because ". . . the redemption was effected in accordance with the terms of the debentures." Id. at 732.

(j) In the foregoing discussion, the Court has assumed that the restriction was valid under section 202(c)(1). However, the nature of the restriction has led the Court to find that the option is not validated per se under subsection (c)(1), but must be tested under the reasonableness standard of subsection (e). Under that standard, the option was invalid as exercised. Professor Folk, Official Reporter and Adviser to the Delaware Committee on the Revision of the General Corporation Law, has summarized the factors to be weighed in determining the validity of a restriction under section 202(e):

> "[A]pplying the common law test normally involves balancing the need for the restriction and the traditional judicial policy favoring free transfer of securities. Weighed in this balance would be the size of the corporation, its purposes, the number and character of its stockholders, the possibility that outsiders may harm the corporation by acquiring its stock, the strictness and duration of the restraint itself, and the availability of a lesser restraint to serve the professed need." The Delaware General Corporation Law, supra, at 200.

Lawson v. Household Finance Corp., 152 A. 723 (Del. 1930); *Greene v. E. H. Rollins & Sons, Inc.*, 2 A.2d 249 (Del. Ch. 1938); *Tracey v. Franklin*, 67 A.2d 56 (Del. 1949). *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, supra (applying Delaware law).

(k) Since plaintiffs do not attack the validity of the restriction on its face, but only as applied after the July 14, 1970, decision to go public, the Court assumes that the restriction was valid before the decision to go public. See *Ling & Co. v. Trinity Savings and Loan Ass'n*, 482 S.W.2d 841 (Tex. 1972).

(l) Article VI of the Merrill Lynch Certificate of Incorporation states that the restrictions are imposed "in order to enable

the Corporation to qualify for membership privileges on various securities exchanges . . . and in order to insure that the business of the Corporation will be carried on in a manner consonent with the Corporation's responsibilities to the public as an organization so qualified." The Corporation, in a February 19, 1971, letter to the Internal Revenue Service regarding tax treatment of cancellation of the restrictions in connection with the public offering, stated that the restrictions ". . . were imposed solely to implement the Exchange restrictions upon ownership of stock in a member corporation." The Court, in *Tracey v. Franklin*, supra, 67 A.2d at 59, clearly held that ". . . unless restraints are imposed for purposes recognized as sufficient, they will be held invalid." Similarly, in *Greene v. E. H. Rollins & Sons, Inc.*, supra, 2 A.2d at 252, the Court invalidated a restraint which was not shown to be ". . . reasonably necessary to advance the corporation's welfare and promote business success." Under this standard, once the stated sole purpose of a restraint fails, the restraint itself becomes invalid. By their own words, defendants have shown their contractual rights to be contingent on the Exchange requirements. The Exchange requirements could have been met by merely removing all restrictions from all stock at any time after March 26, 1970.

(m) Defendants argue that even if the stated purpose of the restraint was no longer valid, other valid purposes, such as making stock available for the employee stock purchase plan, were served. In support of this contention defendants cite *Ryan v. J. Walter Thompson Co.*, 453 F.2d 444, 446 (2d Cir. 1971), cert. denied, 406 U.S. 907 (1972). In *Ryan*, the plaintiffs contended that the call options when exercised were invalid because their underlying purpose, employee ownership of the stock, was no longer valid once the corporation had decided to go public. The Court rejected this argument on the grounds that, ". . . under New York law . . . regardless of the corporate policy underlying the option agreement, such agreement

would be invalid only if it prevented transfer of the stock, as opposed to merely delaying transfer." 453 F.2d at 446. This may be a correct reading of New York law, but Delaware law is clearly to the contrary. The Court, in *Greene v. E. H. Rollins & Sons, Inc.*, supra, held a first option invalid where the purported purpose, a policy of employee ownership of stock, was not a true policy of the corporation and had never before been consistently followed. Accord, *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, supra.

(n) Defendants' argument that the restriction remained necessary to maintain the corporation's exemption from section 12(g) of the Securities Exchange Act of 1934 and from section 4(l) of the Securities Act of 1933 is without merit since a lesser restraint could have been used to accomplish the same purpose.

(o) Defendaints also argue that even if the decision to go public were made in July 14, 1970, they were still required by the rules of the New York Stock Exchange to maintain the restrictions until they actually had freely transferable stock outstanding. This argument is refuted first by defendants' decision not tc exercise the call option on several employees who died after April 8, 1971, the date when the Board was first informed of the decision to go public, and June 23, 1971, the date of the public offering. Their contention that the transferee trust was ineligible under the Exchange rules, since two of the plaintiff trustees were engaged in the securities business with a firm other than the member corporation, is likewise belied by previous action of defendants in allowing potential transferees an opportunity to arrange their affairs so they could qualify. The Exchange requirements that the corporation keep a certain percentage of its stock in the hands of active employees, have a call option as to each class of stock "none of which is to be freely transferable," and maintain the necessary restrictions in

its corporate charter did not require that the defendants exercise the options maturing after the July 1970 decision to go public. The defendants had a comfortable cushion in meeting the Exchange's active employee percentage requirement.

(p) As additional protection in case the ratio shifted out of line with the Exchange requirements (as to percentages of stock owned by employees) before the public offering was completed, defendants could have availed themselves of the section (1)(g) option which was exercisable whenever necessary for the welfare of the corporation. The defendants were protected from charges of discrimination for not strictly exercising all matured options by the section 2 waiver clause, used previously in selected cases.

(q) In addition to *Ryan v. J. Walter Thompson Co.*, supra, defendants cite as controlling *Blackett v. Clinton E. Frank, Inc.*, 379 F.Supp. 941 (N.D.Ill. 1974). In that case, a former chairman of the Board challenged a call exercised upon his involuntary termination on the grounds that the corporation had failed to disclose that it had decided to go public, to declare for the first time a cash dividend, and to split its stock on a two-for-one basis. The Court found that the corporation maintained a strict policy of employee ownership, and that plaintiff had signed a written agreement reciting that the corporation was "required" to purchase the shares, and specifically referring to the possibility of a public offering, stating that the agreement would continue to apply until such time as a registration statement became effective or the corporation was listed on a stock exchange. The Court held that the restriction, because of its specific terms and because plaintiff had not properly pleaded its invalidity, was valid as exercised.

(r) Defendants argue that even if the restriction was invalid as exercised, they have not violated Rule 10b-5 since the allegedly nondisclosed material inside information was, in fact,

available to plaintiffs through extensive newspaper publicity given to the potential public offering. It is true that a 10b-5 claim cannot be based on failure to disclose facts which were publicly available or to which plaintiff had access from other sources. *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir. 1974), cert. denied, 419 U.S. 830 (1974); *Johnson v. Wiggs*, 443 F.2d 803 (5th Cir. 1971). However, plaintiffs, although they may have been aware of the general possibility of a public offering at some indefinite time in the future, clearly did not know of the viable nature of such an offering. A proper exercise of their decision to sell necessitated such knowledge. It would be incongruous to hold a member of the public to such a standard of knowledge in November and December of 1970 when the Corporation's own former chairman of the Board testified that he would not have retired in December of 1970 had he known of the imminence of the offering.

5. Common Law Fraud

(a) Plaintiffs also charge defendants with common law fraud. In order to determine what substantive law to apply, the Court must look to the choice of law rules of Missouri, the forum state. *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487 (1941). Under Missouri's choice of law rules, which follow the most significant contact doctrine adopted in 1 Restatement (Second) on Conflict of Laws, § 145 (1971). Missouri law generally applies since the non-disclosure, the action in reliance upon the nondisclosure, and the pecuniary harm suffered therefrom all took place in Missouri. *General Dynamics Corp. v. Selb Mfg. Co.*, 481 F.2d 1204 (8th Cir. 1973), cert. denied, 414 U.S. 116 (1974); *State ex rel. Brognan v. Nangle*, 510 S.W. 2d 699 (Mo. 1974) (en banc); *Kennedy v. Dixon*, 439 S.W. 2d 173 (Mo. 1969) (en banc).

The elements of common law fraud are:

> ". . . a representation; its falsity; its materiality; the speaker's knowledge of the falsity or his ignorance of its

truth; the speaker's intent that his statement should be acted upon by the person and in the manner reasonably contemplated; the hearer's ignorance of the falsity of the statement; his reliance on its truth; his right to rely thereon; and his consequent and proximately caused injury." *Ackmann v. Keeney-Toelle Real Estate Co.*, 401 S.W. 2d 483, 488 (Mo. 1966) (en banc).

(b) Nondisclosure or silence, as well as active misrepresentation, may constitute fraud:

"It is a general doctrine that, if either party to a transaction conceals some fact which is material, which fact is within his own knowledge, and which it is his duty to disclose, he is guilty of fraud . . . [T]he buyer is [not] bound to reveal all facts known to himself which would enhance the value of the article sold or affect the conduct of the vendor (except where the parties stand in some fiduciary relationship to each other involving the requisite exercise of good faith.)" *Ash Grove Lime & Portland Cement Co. v. White*, 238 S.W.2d 368, 372 (Mo. 1951).

See *Miller v. Higgins*, 452 S.W.2d 121 (Mo. 1970); *Hockenberry v. Cooper County State Bank*, 88 S.W.2d 1031 (Mo. 1935).

(c) Although Missouri law generally applies to this claim, the extent and nature of the relationship between the corporation and the stockholder must be determined under the law of Delaware, the state of incorporation. See *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); 1 Restatement (Second) on Conflict of Laws, § 309 (1971). Under Delaware law ". . . directors generally do not occupy a fiduciary position vis a vis individual stockholders in direct personal dealings as opposed to dealings with stockholders as a class." *Kors v. Carey*, 158 F.2d 136, 143 (Del. Ch. 196..). However, such duty does arise ". . . in special cases where advantage is taken of inside information" as where "a buyer possessed with special knowledge of future

plans or of secret and untapped resources deliberately misleads an ignorant stockholder." Id. Accord, *Lank v. Steoiner*, 224 A.2d 242 (Del. 1966). Missouri seems to follow the same rule. See *Gieselmann v. Stegeman*, 443 S.W.2d 127 (Mo. 1969); *Morrow v. Franklin*, 233 S.W. 224 (Mo. 1921); *Wann v. Scullin*, 109 S.W. 688 (Mo. 1908).

(d) Defendants, as officers and directors in possession of inside information which could have a significant impact on the value of plaintiffs' stock, had a fiduciary duty to disclose such information and acted fraudulently in failing to disclose that information to plaintiffs before purchasing their stock. Defendants' arguments regarding the Corporation's contractual right to purchase the stock, plaintiffs' knowledge of the offering and the uncertainty of the offering at the time of the purchase are rejected for the reason set forth in the discussion of plaintiffs' Rule 10b-5 claim.

(e) Since the fraudulent acts of the individual defendants were committed while they were acting within the scope of their authority and in the course of their employment as officers and directors of Merrill Lynch, the Corporation, as well as individual defendants, is liable to plaintiffs. *Webb Agency, Inc. v. Commercial Standard Ins. Co.*, 333 F.Supp. 966 (E.D.Mo. 1971); *United States v. U.S. Cartridge Co.*, 198 F.2d 456 (8th Cir. 1952), cert. denied, 345 U.S. 910 (1953). Additionally, the Corporation received the benefit of the acts of its officers in recalling stock that became approximately three times more valuable than the acquiring price, and it took no steps to rescind the transaction.

6. **Breach of Fiduciary Duty**

Under Missouri choice of law rules, supra, Delaware law determines the existence and extent of a director or officer's liability for a breach of fiduciary duty to the corporation's stockholders.

Under *Kors v. Carey*, supra, and for the reasons stated above, individual defendants as officers and directors owed plaintiff shareholders a fiduciary duty to disclose the pending public offering before purchasing their stock. Because individual defendants were acting within the scope of their authority and employment, the Corporation is also liable for its employees' tortious conduct. See *Soraghan v. Henlopen Acres, Inc.*, 236 F.Supp. 489 (D.Del. 1964).

7. **Damages**

(a) At the time the defendant Corporation exercised the call to purchase the 40,000 shares at book value from the Bitting estate, it allowed Mr. Bitting's widow to purchase 10,000 shares at book value. Because of the substantial identity of interest between Mr. Bitting's estate and Mrs. Bitting, damages will be based on 30,000 rather than 40,000 shares

(b) The measure of damages for a defrauded seller under Rule 10b-5 is the difference between the price received and the fair value of what the seller would have received had there been no fraudulent conduct, here the value of the stock at the time of the transaction. *Affiliated Ute Citizens v. United States*, supra; *Ross v. Licht*, 263 F.Supp. 395 (S.D.N.Y. 1967). The evidence establishes that plaintiffs' stock was worth approximately $75.00 per share at the time that defendants purchased it for $26.597 per share, or $48.403 less per share than the plaintiffs were entitled to receive. While the 30,000 shares at issue had a fair value of $2,250,000, plaintiffs were paid only $797,910. Their loss, accordingly, is 30,000 times $48.403, or a total of $1,452,090, which amount is awarded as actual damages.

(c) An award of prejudgment interest for violation of Rule 10b-5 rests within the equitable discretion of the Court. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 516 F.2d 172 (2d Cir. 1975), petition for cert. filed, 44 U.S.L.W. 3215 (U.S. Oct. 7, 1975) (No. 353). Interest will be assessed at the rate of six percent simple interest per annum on the sum of $1,452,090, from January 1, 1971

(d) Punitive damages are not recoverable under Rule 10b-5 since recovery is limited under section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a), to actual damages, *deHaas v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970); *Myzel v. Fields*, 386 F.2d 718, 748 (8th Cir. 1967) (dictum), cert. denied, 390 U.S. 951 (1968). However, punitive damages may be awarded when available under state law in an action where state law violations are joined with the federal claim. *Coffee v. Permian Corp.*, 474 F.2d 1040 (5th Cir. 1973), cert. denied, 412 U.S. 920 (1973).

(e) Punitive damages, which are awarded by way of punishment to deter defendants from future similar acts of misconduct, are recoverable in Missouri where defendant's tortious conduct was willful, wanton, malicious, or so reckless as to be in utter disregard of the consequences. *Genie Machine Products, Inc. v. Midwestern Machinery Co.*, 367 F.Supp. 897 (W.D.Mo. 1974); *McClellan v. Highland Sales & Investment Co.*, 484 S.W.2d 239 (Mo. 1972); *Warner v. Southwestern Bell Telephone Co.*, 428 S.W.2d 596 (Mo. 1968). Punitive damages are similarly available under Delaware law. *Sheats v. Bowen*, 318 F. Supp. 640 (D.Del. 1970). This is a proper case for punitive damages. Defendants, in conscious disregard of plaintiffs' legal rights and owing plaintiffs a fiduciary duty, deliberately availed themselves of material inside information and increased the value of their holdings three-fold at plaintiff's expense. A total of 670,000 pre-split shares were illegally called after the decision to go public, netting the Corporation a gain of approximately $38,000,000. Punitive damages are awarded in the amount of $2,000,000, approximately the amount of the judgment with the interest included. The award of actual damages, interest, and punitive damages is made to the plaintiffs jointly against all defendants.

Dated this 24th day of March, 1976.

/s/ JAMES H. MEREDITH
United States District Judge

APPENDIX B

United States District Court
Eastern District of Missouri
Eastern Division

St. Louis Union Trust Company, a Corporation. Kenneth H. Bitting, Jr., William C. Bitting, and George C. Bitting, as Executors of the Last Will of Kenneth H. Bitting, Deceased, Plaintiffs, vs. Merrill Lynch, Pierce, Fenner & Smith, Incorporated, a Corporation, Donald T. Regan, George L. Shinn, and Ned B. Ball, Defendants.	No. 73 C 373 (1).

JUDGMENT

(Filed in U.S. District Court March 24, 1976)

Findings of fact and conclusions of law filed this date are hereby incorporated into and made a part of this judgment.

It Is Hereby Ordered, Adjudged, and Decreed that the plaintiffs be and are hereby granted judgment against defendants jointly for actual damages in the sum of $1,452,090, plus interest at the rate of six percent per annum from January 1, 1971, and punitive damages in the sum of $2,000,000.

Dated this 24th day of March, 1976.

/s/ JAMES H. MEREDITH
United States District Judge

APPENDIX C

United States Court of Appeals for the Eighth Circuit

No. 76-1447

St. Louis Union Trust Company, a Corporation, Kenneth H. Bitting, Jr., William C. Bitting and George C. Bitting, as Executors of the Last Will of Kenneth H. Bitting, Deceased, Plaintiffs-Appellees, v. Merrill Lynch, Pierce, Fenner & Smith Incorporated, a Corporation, Donald T. Regan, Ned B. Ball and George L. Shinn, Defendants-Appellants.	Appeal from the United States District Court for the Eastern District of Missouri

Submitted: April 13, 1977

Filed: August 26, 1977

Before Heaney, Ross and Stephenson, Circuit Judges.

Ross, Circuit Judge.

This appeal raises substantial questions concerning the validity of an option held by Merrill Lynch, Pierce, Fenner & Smith, Inc. (hereinafter Merrill Lynch) to repurchase its own stock from a deceased shareholder's executors. The district court found violations of the securities fraud provisions of § 10b of the Securities Exchange Act of 1934[1] and Rule 10b-5[2]

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[1] 15 U.S.C. § 78j.

[2] 17 C.F.R. § 240.10b-5.

thereunder, as well as common law fraud and breach of fiduciary duty under state law.[3] *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 412 F.Supp. 45 (E.D. Mo. 1976). The district court awarded the plaintiffs $1,452,090 plus prejudgment interest in actual damages and $2,000,000 in punitive damages. *Id.* at 61-62. We hold that the plaintiffs were not entitled to relief on their federal and state claims as a matter of law. Accordingly, we reverse and order the complaint dismissed.

The plaintiffs are the executors of the Estate of Kenneth H. Bitting, a former officer, employee and stockholder of Merrill Lynch. The defendants are Merrill Lynch and three of its senior executives, Donald T. Regan, Ned B. Ball and George L. Shinn.

In 1947, Kenneth Bitting operated a stock brokerage partnership known as Bitting, Jones & Company in St. Louis, Missouri. In that year, the Bitting partnership merged into Merrill Lynch, which was then a national stock brokerage partnership, and became the St. Louis office of Merrill Lynch. Between 1947 and 1951, Bitting was an employee of the Merrill Lynch partnership. In 1951, he became a general partner of the firm.

In 1959, the Merrill Lynch partnership was dissolved and the business was incorporated. In return for their interests in the partnership, each partner, including Kenneth Bitting, received shares of common stock in Merrill Lynch. Bitting received 9,100 shares of voting stock and a $58,000 debenture in exchange for his partnership capital. In October 1959, Merrill Lynch split its stock on a three for one basis and Bitting became the owner of 27,300 shares of voting stock. Bitting had acquired all of his stock at a cost based on book value.

[3] The federal and state claims are properly before us. Federal question jurisdiction exists with respect to the securities fraud claim and diversity jurisdiction exists with respect to the state claims.

Under Merrill Lynch's original Certificate of Incorporation, all common stock, including that issued to Kenneth Bitting, was restricted against transfer. Under the terms of the Charter, Merrill Lynch was granted an option to purchase the holder's stock at an adjusted net book value price upon the occurrence of several specified contingencies, including the death of the holder. This transfer restriction was conspicuously noted on each stock certificate. Likewise the stockholder or his executors were given a right to "put" the stock to Merrill Lynch and it was then required to purchase that stock at book value.

In 1962, Bitting retired from the company. At that time, in accordance with company policy, he exchanged his 27,300 shares of voting stock for over $400,000 in cash and 10,000 shares of nonvoting stock. Between 1962 and 1970, Bitting became the owner of 40,000 shares of nonvoting stock as a result of two additional stock splits.

On October 8, 1970, Kenneth Bitting died. Pursuant to its Charter, Merrill Lynch exercised its option to purchase the 40,000 shares at a price of $26.597 per share, the net book value as of October 30, 1970. The option was exercised by the company on November 18, 1970.[4] The total price was $1,063,880. Thereafter the corporation offered Bitting's widow an opportunity to purchase 10,000 shares of nonvoting stock at the same price, which she accepted. Some other widows had been given similar options.

Between 1959 and 1971, Merrill Lynch was a privately held company. On April 12, 1971, the company publicly an-

[4] The plaintiffs have proceeded throughout this litigation under the erroneous impression that the individual defendants—Regan, Ball and Shinn—were somehow responsible for the enforcement of the stock restriction against the Bitting executors. However, the defendants did not enforce the Bitting stock restriction—indeed they had no power to do so in November 1970. That power resided only with James E. Thompsen, then Chairman of the Board, who, the record shows, undertook the enforcement of the stock restriction not only as to Bitting but as to other deceased stockholders.

nounced that it was "going public"—that it was going to make its shares available to the public. On June 23, 1971, following registration with the SEC and a three for one stock split, four million shares of the company's stock were offered to the public at a price of $28 per share. The offering price per share was approximately three times the price which was paid to the Bitting executors in accordance with the terms of the stock restriction contained in Merrill Lynch's Certificate of Incorporation.

The plaintiffs' complaint is grounded on allegations that the decision to go public in the spring of 1971 was made by a tightly knit group of insiders within the company's management hierarchy before the company purchased the Bitting stock.[5] The plaintiffs say that their stock was purchased in furtherance of a fraudulent scheme on the part of the inside group to enhance the price at which the company's stock was to be offered to the public and to maintain and preserve their control of company management after public ownership.

After a nonjury trial, the court substantially adopted the plaintiff's theory of the case. The court held that the option was unenforceable under Delaware law and was fraudulently exercised by the defendants to the detriment of the plaintiffs in order to increase the per share earnings of Merrill Lynch stock prior to the public offering and to maintain management control.

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[5] The plaintiffs' position is that the "decision" to go public in the spring of 1971 was made by the individual defendants on July 14, 1970, at which time the board of directors approved the formation of a legal and accounting task force to conduct a legal and accounting audit preparatory to public ownership decisions. The plaintiffs say that the Task Force, at the direction of the individual defendants, secretly undertook all necessary steps for public ownership in the spring of 1971 without authority from the board of directors. Between July 1970 and April 1971, the Task Force engaged the accounting firm of Haskins & Sells to prepare financial statements and a ten-year audit for inclusion in the registration statement. The Task Force also engaged attorneys to draft a prospectus.

I. The Enforceability of the Stock Restriction

We first address the issue of whether the stock restriction was enforceable under Delaware law[6] when the stock option was exercised in November 1970.[7] The district court held that the option was not enforceable at that time. We disagree and hold that the restriction was enforceable under § 202(c)(1) of the Delaware General Corporation Law.

Article VI, Section 1(a) of the Merrill Lynch Certificate of Incorporation, the provision under which Kenneth Bitting's stock was called, provides in pertinent part as follows:

> * * * [I]n the event of the death * * * of any holder of common stock of the Corporation * * *, the Corporation shall have the right and option which shall be prior to any other right and option, to purchase the shares of common stock of the Corporation held by the deceased * * * for a period of ninety (90) days from the earlier of: (i) the date the Corporation receives from the legal representative of such holder written notice * * * of the death * * * of such holder, or (ii) the date the Corporation mails written notice * * * that the Corporation is on notice of such death * * *

This restriction was noted conspicuously on each Merrill Lynch stock certificate and was indisputably assented to by Bitting

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[6] All parties agree that the Delaware law controls the determination of the enforceability of the stock restriction.

[7] We consider the transaction date to be the date on which Merrill Lynch exercised its option to repurchase as distinguished from the date of death or the date of actual payment. On November 18, 1970, Merrill Lynch was absolutely legally obligated to purchase this stock, and the case must be decided on the basis of the facts up to and including that date. Although not necessary to the decision in this case, we have examined the record carefully and have reached the conclusion that there was no fraud on the part of the defendants prior to November 18, 1970, at least as such alleged fraud may have applied to Bitting. To the extent that the district court held to the contrary, we consider his factual findings to be clearly erroneous.

when the stock was issued to him. There has been no contention, nor could there be on this record, that Bitting's assent was induced by fraud, deceit or any other improper motive.

The enforceability of the restriction rests on our construction of Section 202 of the Delaware General Corporation Law, which was in existence in November 1970 when the restriction was enforced. Section 202(a) carries the label "Restriction on transfer of securities" and reads as follows:

> A written restriction on the transfer or registration of transfer of a security of a corporation, if permitted by this section and noted conspicuously on the security, may be enforced against the holder of the restricted security or any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder.

Section 202(c) declares four types of restrictions valid without inquiry into the existence *vel non* of a lawful or reasonable purpose. Section 202(c)(1), the pertinent provision for our purposes, provides as follows:

> (c) A restriction on the transfer of securities of a corporation is permitted by this section if it;
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> (1) Obligates the holder of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities; * * *.

This statute on its face validates the stock restriction at issue. The statute declares the enforceability of any restriction which "[o]ligates the holder of the restricted securities to offer to the corporation * * * a prior opportunity * * * to acquire the restricted securities * * *." That is precisely what Merrill Lynch's Charter required of Kenneth Bitting's estate in this case.

We have not found, and the parties have not cited to us, any reported Delaware decision construing § 202(c)(1). However, in *De Vries v. Westgren*, 119 Pittsburgh L. J. 61 and 109 (C.P. Allegheny County 1970), *aff'd as modified*, 287 A.2d 437 (Pa. 1971), the court enforced a stock restriction requiring a shareholder to offer all of his common stock to the corporation upon the voluntary or involuntary termination of his employment under a Pennsylvania statute *identical* to § 202(c)(1).[8] The defendant shareholder was involuntarily terminated by the company and was sued by the other shareholders when he refused to surrender his shares pursuant to the stock restriction. The court enforced the stock restriction, holding that the option was a legal and enforceable agreement "clearly" within the permissive language of the statute. In affirming, the Pennsylvania Supreme Court held:

> [U]nlike a right of first refusal whereby the appellant could elect to retain his shares and never sell to anyone, the stock purchase agreement requires the appellant to offer his shares to the remaining shareholder upon the termination of his employment. In our view, the requirement that appellant offer his shares, whether or not he wished to retain them, lends a quality of irrevocability to the stock purchase agreement and justifies our treatment of this agreement as an option contract.

Id., 287 A.2d at 438.

The plaintiffs advance the argument, embraced by the district court, that § 202(c)(1) was intended to permit only the exercise of a right of first refusal and not the exercise of an automatic option to purchase triggered by the contingency of death or other circumstance. In accepting this argument, the district court couched the distinction in terms of voluntary transfers

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[8] *See* 15 PA. STAT. ANN. § 1613.1(c)(1) (Cum. Supp. 1977) (Purdon).

permitted by § 202(c)(1), and transfers by operation of law, not permitted by § 202(c)(1). 412 F.Supp. at 57.

The construction urged by the plaintiffs would amount to nothing less than a judicial rewriting of the statute, and we reject it. Section 202(a), which modifies each subsection of the statute *including § 202(c)(1),* provides that a transfer restriction permitted by the section is enforceable against "* * * any sucessor or transferee of the holder including *an executor,* administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or *estate of the holder.*" (Emphasis added.) We perceive this to be at least implicit recognition that repurchase option which became operable on the happening of a specified contingency—including an "involuntary" contingency such as death or incompetency—are permitted under § 202(c)(1). Furthermore, Professor Folk, the Reporter for the Delaware revision commission which prepared the law for adoption, has stated that § 202(c)(1) was intended to validate options to purchase as well as mere rights of first refusal:

> A restriction is valid if it requires the holder of restricted securities *to tender* them to designated persons who must act within a reasonable period of time thereafter. Such a restriction could take the form of a mere first refusal *or of an option to acquire the securities.*

Folk, *The Delaware General Corporation Law,* 198 (1972) (emphasis added); *cf. Ketchum v. Green,* 415 F.Supp. 1367, 1372 (W.D. Pa. 1976); *De Vries v. Westgren, supra,* 287 A.2d at 438. Had the Delaware legislature intended to exclude commonly used and accepted repurchase option such as the transfer restriction before us,[9] it could easily have done so.

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[9] We observe that repurchase options such as the stock restriction in this case have been recognized as serving a number of legitimate business purposes, including restrictive ownership of corporate stock, and have been generally upheld by the courts. *See, e.g., Palmer v. Chamberlin,* 191 F.2d 532, 537-538 (5th Cir. 1951); *cf. De Vries v. Westgren,* 287 A.2d 437, 438 (Pa. 1971). *See generally,* 6 Cavitch, *Business Organizations,* § 113.02[2] at 19-20 (1977).

The plaintiffs' construction would also violate the purpose of § 202(c)(1). That purpose was to broaden, not limit, the circumstances in which such restrictions would be enforced in order to clear up the preexisting uncertain contours of the common law. *See* Arsht & Stapleton, *Analysis of the 1967 Delaware Corporation Law,* 2 P-H Corp.—Delaware 311, 333 (1967); Folk, *The Delaware General Corporation Law,* 197-199 (1972). Before § 202(c) was adopted in 1967, the Delaware courts required that a stock restriction be supported by specific justification, e.g., a reasonable or lawful purpose, to be enforceable. *See, e.g., Greene v. E. H. Rollins & Sons, Inc.,* 2 A.2d 249 (Del. Ch. 1938). What specific justification was sufficient to sustain a restriction under the common law was the subject of much uncertainty. *See* Folk, *The Delaware General Corporation Law,* 198 (1972). It was the purpose of § 202(c) to eliminate this uncertainty by substantively validating a wide variety of commonly accepted stock restrictions such as the provision before us. *Id.* at 198-199.[10]

In holding that § 202(c)(1) does not permit "transfers by operation of law," the district court relied on two cases. *Globe*

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[10] The plaintiffs place considerable reliance on *Greene v. E. H. Rollins & Sons, Inc.,* 2 A.2d 249 (Del. Ch. 1938) and *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.,* 490 F.2d 818, 826-827 (5th Cir. 1974), in arguing that the transfer restriction was unenforceable as an unreasonable restraint on the alienation of their stock. With respect to the *Greene* case, the short of the matter is that the plaintiffs' construction ignores the language and purpose of § 202(c)(1). The *B & H Warehouse* case is inapposite. There the Fifth Circuit, in applying Delaware law, held only that a transfer restriction which had not been included in either the corporation's articles of incorporation or bylaws and had not been assented to by the plaintiff stockholder could not be enforced against the stockholder. The court stated that "* * * if the restriction being contested had been included in the original articles of incorporation, or had been a part of the by-laws when B & H acquired its stock, there would be no question that the restriction would be valid." *Id.* at 825, citing *Lawson v. Household Finance Corp.,* 152 A. 723 (Del. 1930). The restriction in this case was included in the original articles, was conspicuously noted on the face of the stock certificates, and was assented to by Kenneth Bitting.

Slicing Co. v. Hasner, 333 F.2d 413, 415 (2d Cir. 1964), *cert. denied*, 379 U.S. 969 (1965); *Matter of Estate of Riggs*, 540 P.2d 361, 363 (Colo. App. 1975). These cases are wholly inapposite. In both cases the courts held that death would not be presumed to trigger the operation of a repurchase option which did not mention death as a specified contingency. In this case the death contingency was expressly provided in the company's corporate charter and was conspicuously noted on the stock certificates themselves. Neither *Globe Slicing* nor *Riggs* involved the construction of a statute such as § 202(c)(1). Accordingly, we hold that the stock restriction was enforceable under Delaware law.

II. The Federal Securities Claim

Having determined that the stock restriction was enforceable under the appropriate state law, we now turn to the merits of the § 10b and Rule 10b-5 claim. Section 10b of the Securities Exchange Act of 1934 provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> (a) * * *
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The SEC has prescribed Rule 10b-5 to enforce the provisions of § 10b. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

Section 10b and Rule 10b-5 were not intended to bring within their ambit simple corporate mismanagement or every imaginable breach of fiduciary duty in connection with a securities transaction. The gravamen of a § 10b and Rule 10b-5 cause of action is fraud, *viz*, manipulation or deception. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976); *Santa Fe Industries, Inc. v. Green*, 45 U.S.L.W. 4317, 4320 (U.S. Mar. 23, 1977).

Causation in fact is an essential element of a private cause of action for securities fraud under § 10b and Rule 10b-5. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 238 (2d Cir. 1974); *Harris v. American Investment Co.*, 523 F.2d 220, 229 n. 7 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); *Fridrich v. Bradford*, 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied*, 45 U.S.L.W. 3465 (U.S. Jan. 11, 1977). *See generally*, A. Bromberg, *Securities Law, Fraud-SEC Rule 10b-5*, § 8.7(1) at 213-214 (1967). In order to prevail in an action for securities fraud under § 10b and

Rule 10b-5, a plaintiff must show some causal nexus between the defendant's wrongful conduct and his (the plaintiff's) loss.[11] This requirement preserves the basic concept that causation must be proved else defendants could be held liable to all the world. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* 495 F.2d at 239, *quoting from, Globus v. Law Research Service, Inc.,* 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970). As stated in *List v. Fashion Park, Inc.,* 340 F.2d 457, 463 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965):

> * * * [T]he aim of [Rule 10b-5] in cases such as this is to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*—not to establish a scheme of investors' insurance.

The roots of the causation in fact requirement have been the subject of much disharmony. Causation has been most often analyzed in terms of the Rule 10b-5 elements of materiality or reliance. *See, e.g., Affiliated Ute Citizens v. United States, supra,* 406 U.S. at 153-154 (materiality); *List v. Fashion Park, Inc., supra,* 340 F.2d at 462 (reliance). The materiality element requires the plaintiff to show that the misrepresentation or omission would likely have influenced in reasonable or objective contemplation the seller's decision to sell. *Cf. TSC Industries v. Northway, Inc.,* 426 U.S. 428, 449 (1976). The element of

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[11] Some courts and commentators have distinguished between transaction causation and loss causation, the former requiring a connection between the defendant's wrongful conduct and the plaintiff's investment decision (i.e. transaction) and the latter requiring a connection between the defendant's wrongful conduct and the plaintiff's loss. *E.g., Schlick v. Penn-Dixie Cement Corp.,* 507 F.2d 374, 380-381 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975); A. Bomberg, *Securities Law, Fraud-SEC Rule 10b-5,* § 8.7(1) at 215-216 (1967); Note, *The Nature and Scope of the Reliance Requirement in Private Actions under SEC Rule 10b-5,* 24 CASE WESTERN RESERVE L. REV. 363, 380-381 (1973). *But see Schlick v. Penn-Dixie Cement Corp., supra,* 507 F.2d at 384 (Frankel, J. concurring). We perceive little relevance in pursuing this distinction in this case.

reliance traditionally required proof that the misrepresentation or omission actually induced the plaintiff to act differently than he would have acted in his investment decision. *See Myzel v. Fields,* 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968). However, in *Affiliated Ute Citizens v. United States, supra,* 406 U.S. at 153-154, the Supreme Court held that when a Rule 10b-5 violation involves a failure to disclose, positive proof of reliance is not a prerequisite to recovery. The Court said:

> All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. at 153-154 (citations omitted); *see also Chasins v. Smith, Barney & Co.,* 438 F.2d 1167, 1172 (2d Cir. 1970). However, the consensus of authority, to which we ascribe, has declined to read into *Affiliated Ute Citizens* a conclusive presumption of reliance in all nondisclosure cases in which materiality has been established. *See Rochez Bros., Inc. v. Rhoades,* 491 F.2d 402, 410 (3d Cir. 1974); *Carras v. Burns,* 516 F.2d 251, 257 (4th Cir. 1975); *Chelsea Associates v. Rapanos,* 527 F.2d 1266, 1271-1272 (6th Cir. 1975). As the Third Circuit said in *Rochez Bros., Inc. v. Rhoades, supra,* 491 F.2d at 410:

> We do not read this decision to say that the question of reliance *vel non* may not be considered at all in a nondisclosure case, but only that proof of reliance is not required for recovery. If defendant is able to demonstrate that there was clearly no reliance, that is, that even if the material facts had been disclosed, plaintiff's decision as to the transaction would not have been different from what it was, then the non-disclosure cannot be said to have caused the subsequent loss and under the ordinary principles of the law of fraud, recovery should be denied. However, in

> light of the Supreme Court's holding in *Affiliated Ute*, the burden of proof rests squarely upon the defendant to establish the "non-reliance" of plaintiff. (Citation omitted.)

See also Carras v. Burns, supra, 516 F.2d at 257; *Chelsea Associates v. Rapanos, supra*, 527 F.2d at 1271-1272. *See generally*, Note, *The Reliance Requirement in Private Actions under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 606 (1975); Note, *The Nature and Scope of the Reliance Requirement under SEC Rule 10b-5*, 24 CASE WESTERN RESERVE L. REV. 363, 388 (1973). *But see Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-381 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

Whether we analyze the causation issue before us in terms of materiality, reliance or both, the result is the same: causation in fact does not exist as a matter of law under § 10b and Rule 10b-5. Any "loss" which was occasioned by the sale of the Bitting stock to the corporation was not caused by any material omission, fraudulent or otherwise, on the part of the defendants. The purported "loss" was caused by two events unrelated to the alleged fraud: 1) the execution of the stock restriction, which was enforceable under Delaware law,[12] and 2) the death of the shareholder Bitting, the specified contingency which triggered the operation of the stock restriction. Whatever the Bitting executors knew or did not know about a future public offering of Merrill Lynch stock[13] was wholly irrelevant to their decision

[12] We emphasize that the stock agreement was executed in good faith between the contracting parties. The plaintiffs do not claim that the stock restriction became part of the bargain as a result of any fraud in the inception.

[13] What the plaintiffs knew about the prospects of a public offering was hotly disputed at trial. We note in passing that after the death of Kenneth Bitting, plaintiff George Bitting expressed to the company his father's intent that the 40,000 shares be kept in the family because of the prospect that some day Merrill Lynch would go public. Mr. Williamson, the company representative who talked with George

to sell the stock. After Kenneth Bitting died on October 8, 1970, the decision to sell was out of their hands; they were contractually bound to sell under Article VI, Section 1(a) of the Merrill Lynch Certificate of Incorporation if Merrill Lynch exercised its option.[14] Any information concerning the public offering was not "material" in the sense that a reasonable or objective investor, in the plaintiffs' circumstances, would likely have considered it important in making his decision to sell. Likewise, in reliance terms, any information concerning the public offering could not have subjectively influenced the plaintiffs to act differently than they did act in selling the shares to the corporation pursuant to the terms of the stock restriction. The defendants were thus under no obligation—and had no federal "duty" under § 10b and Rule 10b-5—to disclose any infor-

Bitting, told him that his thoughts about a public offering "might" be true but that the company could call the stock irrespective of any future public offering. We also observe that Merrill Lynch's intention to go public at some future time was widely reported in several publications before the Bitting stock was called.

[14] The district court found that Merrill Lynch "* * * had no uniform policy of exercising the options to purchase stock at retirement or death of a stockholder." With respect to the enforcement of options to purchase on retirement, the district court's analysis is irrelevant, although we note that the record appears to support the defendants' claim that the retirement options were uniformily exercised. With respect to the enforcement of options to purchase on death, the district court's finding is clearly eroneous. In each instance between 1959 and April 9, 1971, three days before the company announced it was going public, Merrill Lynch *automatically* exercised its option in full to purchase the shares of voting and nonvoting stockholders who died. The disparate treatment of which the district court spoke resulted from a longstanding company policy permitting certain widows to repurchase a percentage (usually 25%) of their deceased husband's holdings in nonvoting stock as a reward for the husband's faithful service to the company. Mrs. Bitting was treated substantially the same as those widows who were accorded this privilege. She was permitted to repurchase 25% of her husband's holdings in nonvoting stock.

The district court relied heavily on what it perceived to be favoritism in the administration of the Charles E. Merrill Trust. The facts belie any finding of favoritism. The Merrill Trust had nothing to do

mation to the plaintiffs concerning the public offering when the stock restriction was enforced.[15]

The decided cases support our conclusion. In *Ryan v. J. Walter Thompson Co.*, 453 F.2d 444, 447 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972), the defendant company enforced a stock restriction enabling it to repurchase its stock from holders who either desired to sell or ceased to be officers or employees of the company. Ryan, a vice-president and director of the company, retired on January 31, 1966. On January 14, 1969, several months after the company had undertaken preparations to offer some of its stock to the public, but several months before the public offering took place, the company enforced the stock restriction. Ryan sued, claiming that the company's failure to disclose its contemplated public offering in connection with the sale constituted a violation of § 10b and Rule 10b-5. In affirming the district court's dismissal of the securities fraud claim, the Second Circuit said:

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with the enforcement of a stock option at the death of a shareholder. The Trust itself was a shareholder—indeed had been since Merrill Lynch was incorporated—of the corporation. It is true that the Trust and the corporation entered into a contract permitting 10% of the stock of the Trust to be sold each year over a period of ten years, the last year being 1976. The purpose for the contract was completely innocent however. Merrill Lynch was fearful that it would be unable to redeem all of the stock held by the Trust at any one time as it could have been forced to do under the Certificate of Incorporation. The corporation therefore opted for gradual assimilation of the stock into the company. It is also true that the 1969 sale of shares was deferred *pursuant to the terms of the contract* until 1971. However, this decision was not motivated by any inside information relating to the public offering. Indeed, the decision to defer the 1969 sale took place on June 19, 1969, more than a year *before* the alleged

[15] The plaintiffs have not suggested how they might have acted differently had they been given prior notice of any company preparations to go public, aside from the observation that they would have taken every possible legal action to protect their interests. However, plaintiffs could have litigated nothing more at that time than they have litigated in this case. The point we wish to emphasize is that plaintiffs could have done nothing to block the sale of the stock. *Cf. Green v. Santa Fe Industries, Inc.*, 45 U.S.L.W. 4317, 4320 n.14 (U.S. Mar. 23, 1977).

> With respect to the Rule 10b-5 claim, the District Court held that, since Ryan was obligated to sell his shares to JWT in January 1969, whatever he knew or did not know regarding JWT's plans to go public was irrelevant. We agree. See *Fershtman v. Schectman*, 450 F.2d 1357, 1360 (2d Cir. 1971). Ryan's reliance upon *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc, *cert. denied*, 394 U.S. 976 (1969), is misplaced. Even under the broadest interpretation of the language of *Texas Gulf Sulphur*, Rule 10b-5 does not spread a comfortable canopy to keep Ryan out of the inclement weather.

Id. at 447.

In *Fershtman v. Schechtman*, 450 F.2d 1357 (2nd Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972), cited with approval in the *Ryan* case, the limited partners of a partnership sued the general partners under § 10b and Rule 10b-5 claiming, *inter alia*, misrepresentations and nondisclosures in connection with a forced sale of the plaintiffs' interests pursuant to the termination of the partnership. In affirming the district court's dismissal of the complaint, Judge Friendly said:

> * * * [I]f the defendants were legally entitled to terminate the partnership on March 31, 1968, in their sole discretion, it would make no difference what they misrepresented or concealed, even if we assume in plaintiff's favor that this transaction constituted a sale.

Id. at 1360.

Ketchum v. Green, 415 F.Supp. 1367 (W.D. Pa. 1976), involved the enforcement of a duly executed stock restriction against the plaintiffs, who were squeezed out of their managerial positions by a majority of the board of directors. After the plaintiffs' employment was terminated, they were required to sell to the company all of their stock pursuant to the stock

restriction which required such a sale "on [the employee's] termination of employment for any reason or on his death." The plaintiffs sued under § 10b and Rule 10b-5, alleging damages resulting from the fraudulent forced sale of their stock at less than market value. Judge Teitelbaum dismissed the claim, reasoning as follows:

> Obviously, neither objective materiality nor subjective reliance is present here. Plaintiffs were contractually bound to sell their shares to [the company] upon termination of their employment. They had no choice in this matter at the time of the operative events in this case. Clearly, the alleged fraud could not have influenced a reasonable man's decision to sell his stock to [the company] after termination when that man had previously committed himself to such a sale; nor could plaintiffs themselves have relied on allegedly fraudulent acts occurring long after plaintiffs had contracted to make the sale in question.

Id. at 1371-1372.[16] *See also Lawrence v. Sudman*, 70 F. Supp. 387, 394-396 (S.D. N.Y. 1945); *Bank v. Fleisher*, 419 F. Supp. 1243, 1248-1251 (D. Neb. 1976).

In *Blackett v. Clinton E. Frank, Inc.*, 379 F.Supp. 941 (N.D. Ill. 1974), a former employee of the defendant corporation brought a § 10b and Rule 10b-5 action agianst the company and its chief executive officer in connection with the enforcement of a duly executed stock purchase agreement which, like the stock restriction in this case, was enforceable under Delaware law. The stock purchase agreement required the corporation to purchase, and the stockholder or his personal representatives to sell, the stockholder's shares in the event of death or termination of his employment. The plaintiff's employment was terminated and the company enforced

[16] The Third Circuit has recently affirmed the district court's disposition in *Ketchum v. Green*, No. 76-2268 (3d Cir., filed June 30, 1977), slip op. at 13-14.

the restriction. The plaintiff alleged that the defendants had fraudulently failed to disclose, *inter alia*, the prospect of a public offering of the company's stock in enforcing the restriction. Judge Bauer dismissed the complaint because the sale of the plaintiff's stock was in no way induced or caused by any misrepresentations on the part of the defendants. He said:

> Since the plaintiff was obligated by the 1969 Stock Purchase Agreement to sell his shares of [the company] at the time of his termination, whatever he knew or did not know regarding [the company's] plans to go public * * * was irrelevant. Clearly, the plaintiff has not properly alleged, nor do the relevant pleadings support a conclusion, that the plaintiff was fraudulently induced into selling his shares of [the company] by the material misrepresentations made by the defendants. In fact, the plaintiff apparently had no choice in the matter; he was obligated to sell his stock pursuant to the provision of the 1969 Stock Purchase Agreement as soon as [the company] had terminated his services.

Id. at 947.

Stripped of all its rhetoric, the plaintiffs' claim under § 10b and Rule 10b-5 boils down to the following: 1) the stock restriction served no valid corporate purpose in November 1970 and was thus unenforceable; 2) the defendants owed to the plaintiffs a supervening (between the execution and enforcement of the stock restriction) fiduciary duty of fair dealing; and 3) the defendants breached this duty by fraudulently enforcing the stock restriction without disclosing their preparations to take the company public. The plaintiffs cite numerous cases to support their theory. *See, e.g., Schoenbaum v. Firstbrook*, 405 F.2d 215, 218-220 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); *Drachman v. Harvey*, 453 F.2d 722, 736 (2d Cir. 1972) (en banc); *Travis v. Anthes Imperial Limited*, 473 F.2d

515, 521-522 (8th Cir. 1973); *Coffee v. Permian Corp.*, 474 F. 2d 1040, 1043-1044 (5th Cir.), *cert. denied*, 412 U.S. 920 (1973); *Bryan v. Brock & Blevins Co., Inc.*, 490 F.2d 563, 569-571 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974); *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283, 1289-1291 (2d Cir. 1976), *rev'd*, 45 U.S.L.W. 4317 (U.S. Mar. 23, 1977); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 993 (7th Cir. 1976); *Speed v. Transamerica Corp.*, 99 F.Supp. 808, 828-829 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956); *Voege v. American Sumatra Corp.*, 241 F.Supp. 369, 375 (D. Del. 1965).

With respect to the first contention, we have previously noted that the stock restriction was enforceable under § 202(c)(1) of the Delaware General Corporation Law without regard for the existence of a "valid" or "lawful" corporate purpose. To the extent the plaintiffs take the position that such a requirement should be superimposed on § 10b and Rule 10b-5, we reject it. In *Santa Fe Industries, Inc. v. Green, supra*, 45 U.S.L.W. at 4321-4322, the Supreme Court stated that § 10b and Rule 10b-5 should not be extended to cover a cause of action which has been traditionally relegated to state law. The Court emphasized that requirements of state corporation law, such as the existence of a "valid corporate purpose" for the elimination of the minority interest in a short form merger, should not be transposed on a § 10b and Rule 10b-5 action because of the danger of vexatious litigation and the potential for interference with state corporate law. *Id.* at 4322 & n. 16. The Court also said:

> Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in *Cort v. Ash* [422 U.S. 66, 84 (1975)], "Corporations are creatures of state law, and investors commit their funds

> to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.

Id. at 4322 (emphasis in original). To require a "justifiable corporate purpose" in this case would impose a more stringent federal fiduciary standard on the defendants than the State of Delaware has itself imposed. As we noted previously, § 202 (c)(1) of the Delaware General Corporation Law declares that transfer restrictions such as the one involved in this case are enforceable without inquiry into the existence of a "valid" or "lawful" corporate purpose. The purpose of § 202 (c)(1) was to clear up the murky state of Delaware common law concerning transfer restrictions by validating such restrictions without necessitating specific justification. *See* Folk, *The Delaware General Corporation Law*, at 198 (1972). We decline to override the Delaware statute, as well as the corporate law of other states,[16a] by extending § 10b and Rule 10b-5 beyond its intended limits. *Cf. Santa Fe Industries, Inc. v. Green, supra*, 45 U.S.L.W. at 4321-4322.[17]

[16a] *See, e.g., De Vries v. Westgren*, 287 A.2d 437, 438 (Pa. 1972), *aff'g as modified*, 119 Pittsburg L.J. 61 and 109 (C.P. Allegheny County 1970).

[17] In *Polin v. Conductron Corp.*, 552 F.2d 797, 815 (8th Cir. 1977), this circuit held that a legitimate business purpose for mergers which have the effect of eliminating private shareholders is of critical importance in appraising the bona fides of the transaction under Rule 10b-5. This holding would appear undermined by the subsequent pronouncement of the Supreme Court in *Green*.

Assuming arguendo, that a lawful or valid business purpose was required, we note that the transfer restriction was justified by a number of lawful and reasonable business purposes. Rule 313.21 of the New York Stock Exchange, of which Merrill Lynch was a member, *required* the company to repurchase the shares of any stockholder who died, so long as the stock was not freely transferable. It is true that on March 26, 1970, the Exchange amended its rules to permit member firms to hold freely transferable securities. However, Rule 313.21 continued to apply to Merrill Lynch until the company

With respect to the second and third contentions, whatever fiduciary duty of fair dealing the defendants might have owed to the plaintiffs in November 1970 was not breached by the enforcement of the stock restriction. The sale was triggered by Kenneth Bitting's death and the corporation's legal entitlement to call the plaintiffs' shares on the happening of that contingency, not by and supervening bad faith on the part of the defendants. In each of the cases cited by the plaintiffs, an improper motive of the control group or a responsible person *caused* the corporation or the affected shareholder to suffer a loss in a transaction it would not otherwise have undertaken. This causation element is not present in this case.

The plaintiffs also rely on *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 45 U.S.L.W. 3416 (U.S. Dec. 6, 1976), in which the plaintiff Ayres, a former employee-shareholder of Merrill Lynch who had voluntarily retired from the company, claimed that the company had violated § 10b and Rule 10b-5 by exercising an option to purchase his stock without informing him of its plans to go public The Third Circuit rejected Merrill Lynch's claim that the nondisclosure was not material as a matter of law. The court distinguished *Ryan v. J. Walter Thompson,*

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had freely transferable stock outstanding. This occurred on June 23, 1971, the date of the public offering, *after* the Bitting stock was purchased. Additionally, 1959, the company obtained an exemption from the registration requirements of the Securities Act of 1933 on the representation to the SEC, *inter alia*, that the Exchange required the company to have an option to purchase the shares on the happening of certain contingencies. In 1967, Merrill Lynch obtained an exemption from the registration and reporting requirements of § 12(g) of the Securities Exchange Act of 1934 on the basis of its representation that it would remain a privately held company by enforcing its stock restrictions. At the time the Bitting stock was purchased, the company could have reasonably believed that the removal of the stock restrictions would have created a public market for the company's stock and, in view of the unavailability of the registration materials, resulted in a violation of the securities laws. Finally, the corporation had a legitimate interest in limiting stock ownership to those persons active in the business.

supra, on the ground, *inter alia*, that Ayres' decision to retire amounted to a voluntary decision to sell and that he could and would have elected not to retire and not to sell his stock had he known of the company's plans to go public. *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra*, 538 F.2d at 537.

Even if we assume the correctness of the *Ayres* decision,[18] it is clearly distinguishable from the case before us. The Third Circuit's rejection of the defendant's causation argument was premised on the critical fact that the stockholder could and would have altered his position had he been apprised of the company's plans to go public. This element is conspicuously absent here. The stock option in this case was triggered by Kenneth Bitting's death, an event wholly uncontrollable by the plaintiffs. The plaintiffs here were powerless to prevent the contingency which gave the company its absolute right to purchase.[19]

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[18] We have serious doubts about the correctness of the majority's disposition in *Ayres*. As Judge Stern pointed out in dissent, Merrill Lynch had an unfettered right to purchase Ayres' stock at any time on 90 days' notice irrespective of its option to purchase when Ayres retired. To the extent that the stockholder had any choice to make, it was not a decision to sell his securities but was rather a decision to retire or not. *Ayres v. Merrill Lynch, Pierce, Fenner & Smith*, 538 F.2d 532, 540 (3d Cir.) (Stern, J. dissenting), *cert. denied*, 45 U.S.L.W. 3416 (U.S. Dec. 6, 1976), citing *Ryan v. J. Walter Thompson*, 453 F.2d 444 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972).

[19] We thus have no occasion to pass on the question of the defendants' obligation to those shareholders who voluntarily retired or otherwise voluntarily triggered the operation of the stock restriction during the period preceding the public offering.

III. **The State Law Claims.**

A. **Common Law Fraud.**

We also reject the district court's holding that defendants were liable under the theory of common law fraud. 412 F. Supp. at 60-61. Under Missouri Law,[20] the elements of common law fraud are as follows:

> * * * [A] representation;[21] its falsity; its materiality; the speaker's knowledge of the falsity or his ignorance of its truth; the speaker's intent that his statement should be acted upon by the person and in the manner reasonably contemplated; the bearer's ignorance of the falsity of the statement; his reliance on its truth; his right to rely thereon; and his consequent and proximately caused injury.

Ackmann v. Keeney-Toelle Real Estate Co., 401 S.W.2d 483, 488 (Mo. 1966). *See also Wilburn v. Pepsi Cola*, 410 F. Supp. 348, 351 (E.D. Mo. 1976) (applying Missouri law); *Wood v. Robertson*, 245 S.W.2d 80, 82 (Mo. 1952). It is clear beyond any doubt that causation in fact is an essential element of an action for common law fraud under Missouri law. *See Jones & Laughlin Steel Corp. v. Sedalia Industrial Loan and Investment Co.*, 315 F.2d 58, 61-62 (8th Cir. 1963) (applying Missouri law); *Bales v. Lamberton*, 322 S.W.2d 136, 138 (Mo. 1959) ("Where a party has not sustained any damages as a result of the fraud charged, it is the general rule that no action for damages may be maintained."); *Mills v. Keasler*, 395 S.W.2d 111, 118 (Mo. 1965). Accordingly, since no causation in fact existed as a matter of law in this case for the reasons expressed in Part II of this opinion, the plaintiffs' common law fraud claim must fail.

[20] We accept the district court's choice of law with respect to the common law fraud claim. *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487, 496 (1941) requires that we look to the forum state, Missouri in this case, to determine what substantive law to apply. Missouri has embraced the most significant contacts doctrine of the RESTATEMENT (SECOND) OF CONFLICT LAWS § 145 (1971) in tort cases, *see Kennedy v. Dixon*, 439 S.W.2d 173, 184-185 (Mo. 1969); *State ex rel. Broglin v. Nangle*, 510 S.W.2d 699, 700 (Mo. 1974); *Trzecki v. Gruenewald*, 532 S.W.2d 209, 211 (Mo. 1976), which classification includes actions for common law fraud, *see General Dynamics Corp. v. Selb Mfg. Co.*, 481 F.2d 1204, 1215-1216 (8th Cir. 1973), *cert. denied*, 414 U.S. 1162 (1974); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 145, 148(2) (1971). Since the plaintiffs are all Missouri citizens and their alleged reliance and pecuniary harm occurred in Missouri, we defer to the holding of the district court that Missouri had the most significant relationship to the transaction. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 148(2) (1971).

[21] Liability for fraud may be premised on a nondisclosure or omission as well. *See Wilburn v. Pepsi Cola*, 410 F.Supp. 348, 351 (E.D. Mo. 1976) (applying Missouri law); *Miller v. Higgins*, 452 S.W.2d 121, 124 (Mo. 1970).

B. **Breach of Fiduciary Duty.**

We lastly consider the merits of the plaintiffs' claim that the defendants breached their fiduciary duty of good faith in enforcing the stock restriction. Again, we accept the district court's choice of law—Delaware law controls the disposition of this claim. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 309 (1971).[22]

Although directors generally do not occupy a fiduciary position with respect to stockholders in face to face dealings, Delaware law does create such a duty in special circumstances where advantage is taken of inside information by a corporate insider

[22] The RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 309 (1971) provides as follows:

> The local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation, its creditors and shareholders, except where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in § 6 to the parties and the transaction, in which event the local law of the other state will be applied.

who deliberately misleads an ignorant stockholder. *See Kors v. Carey*, 158 A.2d 136, 143 (Del. Ch. 1960); *Lank v. Steiner*, 224 A.2d 242, 245 (Del. 1966). Implicit in this formulation of the rule is the element of causation: the stockholder must rely on the misleading representation or omission in order to establish a cause of action for breach of fiduciary duty. *Id.*

As we have previously noted, any information concerning the public offering could not have subjectively influenced the plaintiffs to act differently than they did act in selling the shares to the corporation pursuant to the terms of the stock restriction. The parties were "influenced" only by 1) the lawful execution of the stock restriction, which contractually bound them to sell the stock on the contingency of death, and 2) the death of Kenneth Bitting. The defendants thus had no duty to disclose any information concerning the public offering, since such information was irrelevant to the plaintiffs' investment decision.[23]

The judgment is reversed and the case is remanded with directions to dismiss the complaint.

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[23] The plaintiffs invoke the familiar principle of Delaware law that a duty of good faith dealing is superimposed on the terms of every contract arising in the corporate framework. *See Guth v. Loft*, 5 A.2d 503 (Del. 1939); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769 (Del. Ch. 1967); *Penn Mart Realty Co. v. Becker*, 298 A.2d 349 (Del. Ch. 1972). They reason that even valid corporate machinery cannot be used for any improper motive to injure minority shareholders. *See, e.g., Yasik v. Wachtel*, 17 A.2d 309 (Del. Ch. 1941); *Condec Corp. v. Lunkenheimer Co., supra; Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975).

We have no quarrel with these propositions in the contexts in which they were invoked. However, none of the cases cited by the plaintiffs involved nor control the enforceability of a stock option lawfully executed under Delaware law and legally enforceable under § 202(c)(1) irrespective of specific justification. *Cf. Singer v. Magnavox Co.*, 367 A.2d 1349, 1353-1358 (Del. Ch. 1976). None of these cases even remotely impugns the company's right to exercise a repurchase option which was specifically assented to by the stockholder, consistently exercised by the company and supported by lawful business purposes.

HEANEY, Circuit Judge, dissenting.

I respectfully dissent. I cannot agree with the majority's holding that no breach of a fiduciary duty under Delaware law occurred. The defendants exercised the repurchased options of deceased shareholders for no justifiable business reason. By arbitrarily inflicting injury on a class of shareholders, the defendants failed to exercise that good faith and fair dealing required by Delaware law.[1] *See, e.g., Petty v. Penntech Papers, Inc.*, 347 A.2d 140 (Del. Ch. 1975); *Speed v. Transamerica Corp.*, 99 F.Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3rd Cir. 1956); *Condec Corporation v. Lunkenheimer Company*, 230 A.2d 769 (Del. Ch. 1967).

The majority correctly states that § 202(c)(1) of the Delaware General Corporation Law permits repurchase options as well as rights of first refusal. Such options are not uncommon, especially in close corporations, and serve legitimate business purposes. It also appears that § 202(c) was designed to broaden the circumstances in which transfer restrictions would be allowed. On its face, this transfer restriction was enforceable under Delaware law.

However, the majority's apparent holding, that a repurchase option may be exercised in all circumstances or for any purpose because it no longer must be supported by a specific justification, cannot be supported.

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[1] The defendants would escape responsibility for their actions on the theory that they did not personally exercise any options. I am not persuaded by that defense. The defendants by failing to disclose the decision to go public to those who were responsible for exercising the options made the exercise inevitable. The defendants were well aware of the substantial harm that would occur to shareholders who had their stock redeemed after the decision to go public was made but before the registration was made effective. *St. Louis U. Tr. Co. v. Merrill Lynch, Pierce, Etc.*, 412 F.Supp. 45, 50 (E.D. Mo. 1976).

Section 202(c)(1) may limit a court's inquiry into the reasonableness of the transfer restriction, but it does not foreclose further inquiry into the circumstances of its exercise. Such circumstances may be examined even though the articles or by-laws specifically authorize the transaction. *Petty v. Penntech Papers, Inc., supra; Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971); *Condec Corporation v. Lunkenheimer Company, supra.* The defendants may not merely take refuge in strict compliance with the provisions of Article VI as "inequitable action does not become permissible simply because it is legally possible." *Schnell v. Chris-Craft Industries, Inc., supra* at 439. When dealing with shareholders as a class, control persons have a fiduciary obligation to them, "especially where [the shareholders'] individual interests are concerned." *Petty v. Penntech Papers, Inc., supra* at 143. *And see Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (1960); *Lofland v. Cahall*, 13 Del. Ch. 384, 118 A. 1 (1922). This fiduciary duty requires control persons to exercise good faith and fair dealing. Here, the defendants breached that duty.

Central to the argument that defendants breached their fiduciary duty is the fact that defendants were firmly committed to going public no later than November 18, 1970, the date the option on Bitting's stock was exercised. The trial court fixed the date when the defendants decided to go public as July 14, 1970. While I feel this finding is not clearly erroneous, strong additional evidence exists to indicate that the decision became more entrenched by November 18, 1970. The following facts tend to support this conclusion:

In March and June, 1970, the New York Stock Exchange took action to permit public ownership of member firms and to eliminate the limitations on nonvoting stockholders in member firms. This action coincided with the demonstrated need of Merrill Lynch for additional capital thus establishing the legal basis and economic justification for going public.

On July 14, 1970, a meeting of the defendants was held and a decision to go public was made.

In late July, 1970, the "going public" Task Force was created. It prepared a preliminary timetable calling for the filing of a registration statement with the Securities and Exchange Commission prior to March 31, 1971.

On August 26, 1970, the defendants engaged the accounting firm of Haskins and Sells to perform a ten-year audit of the company and to prepare the financial statements necessary for the registration statement. This audit, which cost Merrill Lynch $400,000 and involved 15,000 accountant hours, is of a type that would not have been made absent a firm intention to go public.

Prior to October, 1970, a legal audit committee was established. On October 7, 1970, a mid-point report on the legal audit was submitted to the Task Force. The report stated: "We are now slightly more than half through the Corporation Accounting and Legal Audit Timetable." The report set forth a timetable that fixed a March 1, 1971, date for filing a registration statement with the S.E.C. This was a full month earlier that that fixed in the preliminary timetable.

On November 18, 1970, a meeting was held with the S.E.C. to discuss the presentation of the Goodbody financial statements in the prospectus.[2] By classifying Goodbody as a nonsignificant subsidiary, separate financial statements of the company were not required in the Merrill Lynch prospectus.

Other significant actions were taken within a few months of Mr. Bitting's death. These are important to the extent they lend support to the finding that a decision to go public had been

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[2] Goodbody, the fifth largest brokerage firm in the country, was rescued from financial collapse by Merrill Lynch at the urgent request of the New York Stock Exchange in November, 1970.

made prior to November 18. Included in these actions are the following:

On December 30, 1970, the defendants determined the size of the offering and decided on a three-for-one stock split prior to the offering. They also concluded that necessary amendments to the articles would be submitted to the Board in March and voted on at the annual stockholders meeting in April.

By January 5, 1971, the first draft of the registration statement was completed. It contained a proposed filing date of March, 1971.

The defendants minimize the importance of the actions listed above and argue that they do not support a finding of a firm intent to go public. They argue that since the registration process could be halted at any time before the registration statement became effective, no final decision was made until the registration process could not be aborted. I find little merit in this argument. The possibility that the defendants could abort the process if later events demanded it does not negate a present intent to go public.

Moreover, it would have been simple and fair to have suspended the exercise of options during any period of uncertainty.[3]

The gravamen of defendants' breach is utilizing a corporate power to seriously injure a shareholder class[4] without a business

[3] The defendants could have alleviated any problems with the running of the ninety-day option period by explaining their intentions to the plaintiffs and working out an agreement extending the option period.

[4] The shareholder class is composed of those shareholders who died between July 14, 1970 and April 9, 1971. The latter is the date when defendants discontinued the policy of exercising options to repurchase stock.

justification.[5] *See Petty v. Penntech Papers, Inc., supra; Schnell v. Chris-Craft Industries, Inc., supra; Condec Corporation v. Lunkenheimer Company, supra; Voege v. American Sumatra Tobacco Corporation,* 241 F.Supp. 369 (D. Del. 1965); *Speed v. Transamerica Corp., supra.*[6] The plaintiffs are within the injured class of shareholders and should be allowed recovery.[7]

The seriousness of the injury to the deceased shareholder class is best illustrated by the plaintiffs' situation. The plaintiffs' stock was redeemed at $26.597 per share. Thereafter, Merrill Lynch split its stock three-for-one and sold it for $28.00 per share.

The trial court determined that at the time the option was exercised, the pre-split value of plaintiffs' stock was $75.00 per

[5] Neither can the defendants claim a business justification. The business reasons set forth as a justification in n.17 of the majority opinion did not suddenly disappear on April 9, 1971, when the decision was made to discontinue exercising options.

[6] Arguably, some improper purpose or self-dealing must be present to find liability. But fraud and self-dealing are not the sole methods of breaching a fiduciary duty. *Penn Mart Realty Company v. Becker,* 298 A.2d 349 (Del. Ch. 1972). A fiduciary need not personally benefit from a transaction constituting a breach. *See, e.g.,* G. Bogert, *Trusts and Trustees* § 543 (2d ed. 1960).

The trial court found that the defendants' actions were part of a scheme to maintain management control and to increase earnings per share so as to increase the public offering price of Merrill Lynch shares. Maintenance of control is an improper purpose under Delaware law. *See, e.g., Bennett v. Propp,* 41 Del. Ch. 14, 187 A.2d 405 (1962). Although unnecessary to this decision, substantial evidence exists to support the trial court's findings.

Moreover, when all transactions, including those of stockholders who retired in the interim period when the stock was repurchased are considered, the direct gain to the defendants was substantial.

[7] This case presents only the issues relating to deceased shareholders and not to those shareholders who voluntarily retired. In *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 538 F.2d 532 (3rd Cir. 1976), *cert. denied,* 97 Sup. Ct. 542 (1976), the Court accurately observes that the decision to retire was, in effect, a voluntary decision to sell as the shareholder could have retained the stock if he had not elected to retire. In my judgment, *Ayres* was properly decided.

share for a loss of $48.403 per share. As plaintiffs owned 30,000 shares, actual damages were computed of $1,452,090.[8] If the plaintiffs had retained the stock until June 23, 1971, when Merrill Lynch went public, the pre-split value would have been $84.00 per share and the loss in excess of $1.7 million.

The defendants' breach of their fiduciary duty is sufficient to sustain the award of actual damages by the trial court. This being the case, it is unnecessary for me to decide whether the plaintiffs established a violation of § 10(b) and Rule 10b-5. I would only note that, in my judgment, *Ryan v. J. Walter Thompson Co.*, 453 F.2d 444 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972), was improperly decided.

The trial court should not have awarded punitive damages. The defendants' actions were not the willful, wanton and malicious type of conduct that punitive damages were designed to punish and deter. *See, e.g., Genie Machine Products, Inc. v. Midwestern Machinery Co.*, 367 F.Supp. 897 (W.D. Mo. 1974).

Neither should the trial court have awarded prejudgment interest. Although equitable principles may be considered, generally Missouri law does not allow prejudgment interest on an unliquidated sum. *General Insurance Co. of America v. Hercules Construction Co.*, 385 F.2d 13 (8th Cir. 1967). *See* V.A.M.S. §§ 408.020 and 408.040.

In all other respects, the judgment should be affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit

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[8] Kenneth Bitting owned 40,000 nonvoting shares at the time of his death, but his widow was allowed to repurchase 10,000 at the redemption price from Merrill Lynch.

APPENDIX D

JUDGMENT

United States Court of Appeals
For the Eighth Circuit

No. 76-1447 September Term, 1976

St. Louis Union Trust Company, a corporation, Kenneth H. Bitting, Jr., William C. Bitting, and George C. Bitting, as Executors of the Last Will of Kenneth H. Bitting, Deceased,
Appellees,

vs.

Merrill Lynch, Pierce, Fenner & Smith, Incorporated, Donald T. Regan, George L. Shinn and Ned B. Ball,
Appellants.

Appeal from the United States District Court for the Eastern District of Missouri.

This Cause came on to be heard on the record from the United States District Court for the Eastern District of Missouri and was argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the judgment of the said District Court, in this cause, be, and the same is hereby, reversed.

And it is further ordered by this Court that this cause be and is hereby remanded to the said District Court with directions to dismiss the complaint in accordance with majority opinion of this Court.

August 26, 1977

APPENDIX E

United States Court of Appeals
For the Eighth Circuit

76-1447 September Term, 1977

St. Louis Union Trust Company, etc., et al.,
Appellees,
vs.
Merrill Lynch, Pierce, Fenner & Smith, Incorporated, et al.,
Appellants.

Appeal from the United States District Court for the Eastern District of Missouri

The Court having considered petition for rehearing en banc filed by counsel for appellees and, being fully advised in the premises, it is ordered that the petition for rehearing en banc be, and it is hereby, denied.

Judge Heaney would have granted the petition for rehearing en banc. Judge Webster did not participate.

Considering the petition for rehearing en banc as a petition for rehearing, it is ordered that the petition for rehearing also be, and it is hereby, denied.

October 27, 1977

APPENDIX F

Title 15, United States Code

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropiate in the public interest or for the protection of investors.

Title 17, Code of Federal Regulations

§ 240.10b-5. Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

in connection with the purchase or sale of any security.